A Case Study:

How Do Nepalese Commercial Banks Comply with Risk Management–Related Corporate Governance Mechanism of the Basel?

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STATEMENT OF AUTHENTICATION

To my best knowledge and belief, the work presented in this thesis is original, except as acknowledged in the text. I hereby declare that I have not submitted this work, either in full or in part, for a higher research degree at this or any other institution.

Sunita Giri
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STATEMENT OF DECLARATIONS

This thesis work is copyedited by *Ms Jessica Cox* from Quick Fox Editing.

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LIST OF ABBREVIATIONS

ASBA	Application Supported by Blocked Amount
BAFIA	Bank and Financial Institution Act
BCBS	Basel Committee on Banking Supervision
BCPs	Basel Core Principles for Effective Bank Supervision
BFIs	Banking and Financial Institutions
BIS	Bank for International Settlements
CBs	Commercial Banks
CEO	Chief Executive Officer
CIT	Citizen Investment Trust
CRO	Chief Risk Officer
CTZN	Citizens Bank International Limited
DBs	Development Banks
EBL	Everest Bank Limited
EPF	Employee Provident Fund
ESP	Economic Stabilisation Program
FCs	Finance Companies
FDI	Foreign Direct Investment
FINGOs	Financial Non-Government Organisations

FSB	Financial Stability Board
FSRs	Financial Sector Reforms
FY	Fiscal Year
GDP	Gross Domestic Product
GFC	Global Financial Crisis
HDR	Higher Degree Research
IB	Insurance Board
ICs	Insurance Companies
ICT	Information and Communication Technology
IMF	International Monetary Fund
KYC	Know Your Customer
LC	Letter of Credit
MFFIs	Microfinance Financial Institutions
MIS	Management Information System
NBL	Nepal Bank Limited
NPR	Nepalese Rupee (currency)
NRB	Nepal Rastra Bank
OECD	Organisation for Economic Co-operation and Development
RBB	Rastriya Banijya Bank

RBS	Risk-Based Supervision
RIC	Reinsurance Company
RMC	Risk Management Committee
SCB	Standard Chartered Bank Nepal Limited
SEBON	Securities Board of Nepal
SRBL	Sunrise Bank Limited
ToR	Term of Reference
UK	United Kingdom
USA	United States of America
USD	US Dollar (currency)
WTO	World Trade Organization

ABSTRACT

While the formal modern banking system in Nepal commenced in 1937, actual financial regulations and supervision of the Nepalese banking industry started only from 1956 when the Central bank of Nepal was established. The Nepal Rastra Bank has been gradually embracing various international best practices for supervising and regulating its banking industry that is suitable for its domestic market need. This project examines the extent to which Nepalese commercial banks are embracing the Basel framework of corporate governance principles for risk management. To do this, it integrated the Basel frameworks with the legal, regulatory framework and relevant prudential rules and regulations that regulate commercial banks of Nepal to understand the concept, principles and practices of corporate governance and risk management. This project contributes to the literature in the field of corporate governance and risk management, particularly in the Nepalese context. It provides a clear and sufficient picture of the risk governance practices of the commercial banks of Nepal in terms of their compliance with the Rastra Bank's risk governance requirements and, simultaneously, with their implementation of the Basel framework of corporate governance principles of risk management.

CHAPTER 1 INTRODUCTION

1.1 Introduction

This research project aims to describe and explain the risk management practices of the Nepalese commercial banks in relation to the Basel's corporate governance principles. This chapter contextualises the research project by reviewing the research setting, identifying the gaps, and defining the objectives of the project. Specifically, Section 1.2 outlines the background of this thesis project. Section 1.3 contextualises the study with an overview describing Nepal, the Nepalese financial system, and the banking sector of Nepal. Section 1.4 identifies the gap in research and explains this project's contribution. Section 1.5 discusses the objective of this project and presents the study's research questions. Section 1.6 provides the structure of the remaining chapters in this thesis. Finally, Section 1.7 contains the conclusion of Chapter 1.

1.2 Background

Risk management in banking is not a new practice, and its importance has been recognised ever since banking has existed. However, the topic of risk management has become and remained a hot topic after the 2008 global financial crisis (GFC) (Bessis 2015). One of the most significant shocks witnessed in the GFC was that both financial and non-financial institutions had weakness in their risk governance mechanisms (Anginer et al. 2019; Dupire & Slagmulder 2019; Financial Stability Board (FSB) 2013; Kirkpatrick 2009; Organisation for Economic Co-operation and Development (OECD) 2009). This weakness in risk governance led to substantial financial losses and corporate failures, leading to the GFC; since then, there has been an increased emphasis on risk management systems and practices. Similarly, countries have either introduced or amended their regulations and legislations to improve the corporate governances of both their financial and non-financial institutions.

In response to the crisis, the Basel Committee on Banking Supervision (BCBS) introduced a new regulatory framework for banks, commonly referred to as Basel III (Apostolik & Donohue 2015; Boora & Kavita 2018; McCracken et al. 2017; Schmaltz et al. 2014). The Basel III is one of the Basel Accords, which have been issued by BCBS. The Basel Accords are

international regulatory standards and protocols, specifically designed for the adoption of international capital standards and the *Basel Core Principles for Effective Bank Supervision* (BCP) (Ayadi et al. 2016; Boora & Kavita 2018). The BCBS provides guidelines and recommendations for mitigating the risks that are inherent to banking business through the Basel Accords (Apostolik, Donohue & Went 2009; Boora & Kavita 2018). Individual countries, however, adopt and implement the Basel Accords in ways that are suitable to their national law and discretion (Scott & Gelpern 2016). Choudhry (2011) states that an individual country's regulator usually adopts the Basel Accords as the minimum required standards. Chapter 2 further discusses the BCBS and the Basel Accords.

The Central Bank of Nepal, the Nepal Rastra Bank (NRB) (also known as the Rastra Bank), has adopted the best international norms and frameworks (Bank Supervision Department 2018). For example, according to the Bank Supervision Department (2002), the Rastra Bank issued a new set of NRB regulations 2001, in the form of the Directives. This set of regulations was based on the *Core Principles of Bank Supervision* of the 1988 Basel Accords published by the Bank for International Settlements (BIS) (Bank Supervision Department 2002). The NRB regulations consisted of Directives under seven headings; one of these included corporate governance (Bank Supervision Department 2002). This initial corporate governance Directive required banks to establish an internal audit committee under the chairpersonship of a non-executive board member (Bank Supervision Department 2002). The Directives also restricted the issuing of loans and advances to promoters of the banks (Bank Supervision Department 2002). This provision helped to reduce the banks' non-performing loans and advances (Bank Supervision Department 2002).

In fiscal year (FY) 2016/2017, the Nepal Rastra Bank added a new clause in the Bank and Financial Institution Act (BAFIA) regarding the eligibility of the chairperson, board of directors or Chief Executive Officer (CEO) of banking and financial institutions (BFIs) through its Unified Directives. In the Unified Directives FY 2016/2017, the Nepal Rastra Bank also barred any elected representatives from becoming the chairperson or board of directors of a BFI (MyRepublica 2017). Section 20 of BAFIA 2017 prohibits any elected representatives from becoming the chairperson, CEO or board of directors of any BFIs. This new rule deliberately blocks members of parliament to take undue advantage by putting pressure on the Central Bank through their political influence (MyRepublica 2017). In January 2017, parliament approved amendments to BAFIA to reinforce the corporate governance of Nepalese commercial banks (International Monetary Fund 2017).

This regulatory initiative of the Rastra Bank intends to strengthen the corporate governance practices further in the Nepalese banking sector (MyRepublica 2017).

The NRB has thus gradually initiated the adoption of international best practices in the Nepalese banking industry to enhance the corporate governance mechanism and manage the risks. However, despite these initiatives by the Rastra Bank, the Nepalese financial system still has a weak corporate governance system and inadequate risk management practices (Bank Supervision Department 2015; Bhattarai 2014; Nepal Rastra Bank 2017; Ozaki 2014). According to the Bank Supervision Department (2019), in the commercial banks of Nepal, the board and senior management's risk oversight function are weak. Initiatives to develop and promote a risk management culture in banks is still inadequate (Bank Supervision Department 2019). Within this context, an exploration of the risk governance mechanism of the Basel Accords – in particular, why, how and which Basel Standards have been adopted in the Nepalese financial system – will help to gain an in-depth understanding of the risk management practices of commercial banks in Nepal.

1.3 Overview of the Study

This section discusses the context of the study, by briefly describing Nepal, its financial system and the banking industry.

1.3.1 Brief Introduction of Nepal

Nepal is a developing economy in South Asia, landlocked between China and India. After the Constituent Assembly of Nepal declared Nepal to be a Federal Democratic Republic Country on 28 May 2008, Nepal promulgated a new constitution on 20 September 2015. Nepal has observed seven constitutions in the last 70 years (Shrestha 2019) and has experienced historic democracy movements since the late 1970s (Ozaki 2014). For instance, the People's Movement of the 1990s established democratic reforms in the country's politics by ending absolute monarchy (World Bank 2019b). On 9 November 1990, the King revoked the constitution of 1962 and ended 30 years of absolute monarchy in politics (Ozaki 2014). However, in February 1996, the Maoist Party launched an armed rebellion against the constitutional monarchy and elected government (Luintel, Selim & Bajracharya 2014; Ozaki 2014; Shrestha 2019; World Bank 2019b). This decade-long, Maoist insurgency in the country ended only in 2005 after peaceful dialogues were initiated between the Maoist and other major political parties in 2002

(Luintel, Selim & Bajracharya 2014). These various people's and political movements in Nepal illustrate that Nepal had undergone a lengthy and complicated transition to federalism (World Bank 2018); also, that the country has faced political instability throughout its history.

As of 2018, Nepal's population was 29.30 million (World Bank 2019a). Nepal's gross domestic product (GDP) was US Dollar (USD) 29.04 billion in 2018 (World Bank 2019c). The country's primary economic activities, including services, manufacturing and agriculture, contributed Nepalese Rupee (NPR) 131,079 million, NPR 56,018 million and NPR 267,458 million, respectively, to the nation's GDP in 2018 (World Bank 2019c). Nepal has also achieved robust economic growth of 7.1% in 2019 (World Bank 2019b). However, Nepal relies heavily on remittances (Shrestha 2019; World Bank 2018). In 2019, it received USD 7.8 billion in personal remittances, which accounted for about 27.989% of the country's GDP (World Bank 2019c). The World Bank (2018) further states that, while foreign direct investment (FDI) accounts for only 0.6% of GDP, it grew strongly by 32% year-to-year in FY 2018. This all-time high contribution by the economic sectors and growth in FDI in 2018 signal that both the country's economic situation and international investors' appetite in Nepal are improving.

1.3.2 Overview of the Nepalese Financial Sector

Compared to other economies, the Nepalese financial system is unique. The Nepalese financial system comprises both banking and non-banking financial institutions (Bank Supervision Department 2018). In particular, the BFIs of Nepal constitute commercial banks, development banks, finance companies and microfinance institutions (Bank Supervision Department 2018). Non-banking financial institutions comprise insurance companies, securities markets, contractual saving institutions, and financial non-government organisations (FINGOs) and cooperatives that carry out limited banking activities and other services (Bank Supervision Department 2018). Appendix 1-1 shows the total number of banking and non-banking financial institutions operating in Nepal, as of mid-July 2018. Figure 1-1 shows the structure of Nepal's financial system. Different regulators, which regulate the banking and non-banking financial institutions (Bank Supervision Department 2018), are discussed in Chapters 2 and 4.

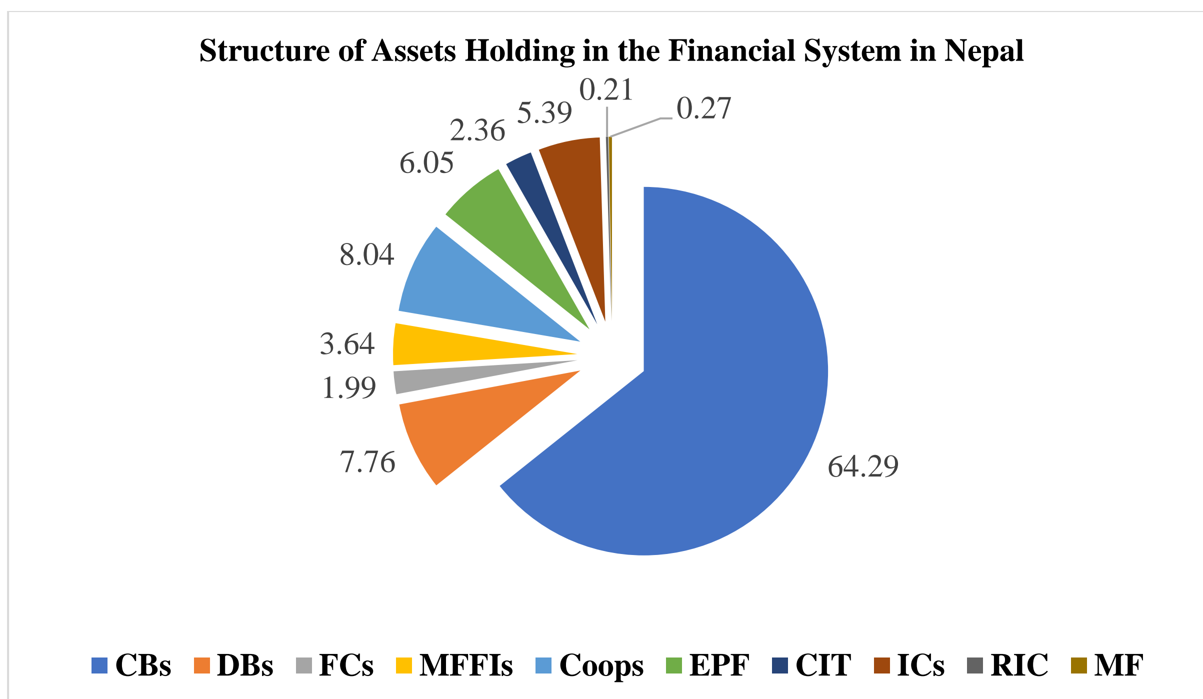

Figure 1-1: Structure of Assets Holding in the Financial System in Nepal

Source: Nepal Rastra Bank (2018)

Apart from differences in the type and structure of banking and non-banking financial institutions operating in Nepal, the Nepalese financial system has some other distinct characteristics. For instance, its financial system has inherent limitations, such as limiting credit rating practices (Nepal Rastra Bank 2013, 2018). This limitation of credit rating practices is one of the constraints in the implementation of Basel III in the Nepalese banking sector because the institutionalisation of credit rating agencies has been essential for implementing Basel III (Nepal Rastra Bank 2018). The Nepalese financial system is also not highly integrated with the global financial system (Uprety 2013). In other words, the Nepalese financial system has relatively low, or no, exposure to international financial markets (Nepal Rastra Bank 2012). It neither has access to international exchanges of local stocks, nor the listing of foreign stocks in local exchanges (Risal & Panta 2019). Likewise, Nepal's money and capital markets are still in their infancy (Sharma 2014). When compared with other economies, the Nepalese banking industry has yet not achieved the level of development and advancement of the international standards (Nepal Rastra Bank 2013, p. 16), and the products and services offered by the Nepalese banking industry are still mostly conventional (Nepal Rastra Bank 2018).

However, these scenarios are changing gradually, especially after Nepal has allowed foreign banks to establish and operate in the Nepalese financial system since 2010 (Nepal

Rastra Bank 2010, 2015a). More importantly, the Rastra Bank's provision has expanded the BFIs' scope of operations. The Rastra Bank has expanded the sources of funding for BFIs (Nepal Rastra Bank 2018), both in term of foreign borrowing and deposits (Nepal Rastra Bank 2019). As seen in Appendix 1-1, the Nepalese financial system now has two credit rating agencies. The banking industry in Nepal has become more complex with the development of new products and the adoption of advanced information and communication technology (ICT) (Bank Supervision Department 2019). For instance, with the advancement and adoption of technology, more people are using ATM cards, and mobile and internet-based banking services to execute financial transactions (Bank Supervision Department 2019). From this increasing scope of operations of BFIs, it promptly follows that the financial system is becoming more complex. The changes in the Nepalese financial system also reflect that it is integrating with other financial systems globally.

1.3.3 Overview of the Nepalese Banking Industry

Various forces, such as financial sector reforms (FSRs), domestic and international economies, and technology, have transformed the Nepalese financial sector. The financial liberalisation policy adopted in the mid-1980s, in particular, brought significant changes to the banking system of Nepal. Luintel, Selim and Bajracharya (2014) confirm that, until 1984, there were only two commercial banks in Nepal. However, with the implementation of financial liberalisation policy, many foreign joint-venture banks and private banks were established in the financial market of Nepal (Bank Supervision Department 2019; Nepal Rastra Bank 2018). Luintel, Selim and Bajracharya (2014) agree that the Nepalese commercial banking segment transformed quickly and deeply after 2002, particularly after the second phase of FSRs. This second phase of reform fully opened the financial sector to the private sector, for both domestic and international investors (Luintel, Selim & Bajracharya 2014). The banking system changed significantly, both in terms of the number and structure of its institutions (Luintel, Selim & Bajracharya 2014; Nepal Rastra Bank 2018). In 2011, the number of BFIs reached a peak of 218, from just 3 in 1985 (Nepal Rastra Bank 2018). Panta and Bedari (2015) confirmed that despite Maoist insurgency and political instability in the country, the banking industry had shown the growth. However, this growth in the number of BFIs stopped in 2012, after the NRB adopted a moratorium on licensing new BFIs in 2011 (Nepal Rastra Bank 2014). Figure 1-2, below, reflects the change in the number of BFIs.

Currently, the Nepalese banking system is undergoing a restructuring and consolidation process, mainly through the moratorium on licensing new BFIs (except for microfinance institutions), the adaptation of policy on mergers and acquisitions, and increase in the paid-up capital requirements (Bank Supervision Department 2019; Nepal Rastra Bank 2018). The NRB has increased the minimum in paid-up capital to promote financial stability, as well as to mobilise the resources required for the nation's long-term development (Nepal Rastra Bank 2015b). For example, the Rastra Bank has increased the regulatory capital requirement of all BFIs, including commercial banks, through its monetary policy FY 2015/2016 (Nepal Rastra Bank 2015b). The minimum paid-up capital requirement, as presented in Appendix 1-2, shows the newly updated paid-up capital of all BFIs. Likewise, the number of BFIs are also decreasing in Nepal because the BFIs are consolidating through the process of merger and acquisition. Figure 1-2 shows the change in the number of financial institutions under NRB jurisdictions from 1985 to 2018. The following section discusses the nature and structure of BFIs of Nepal.

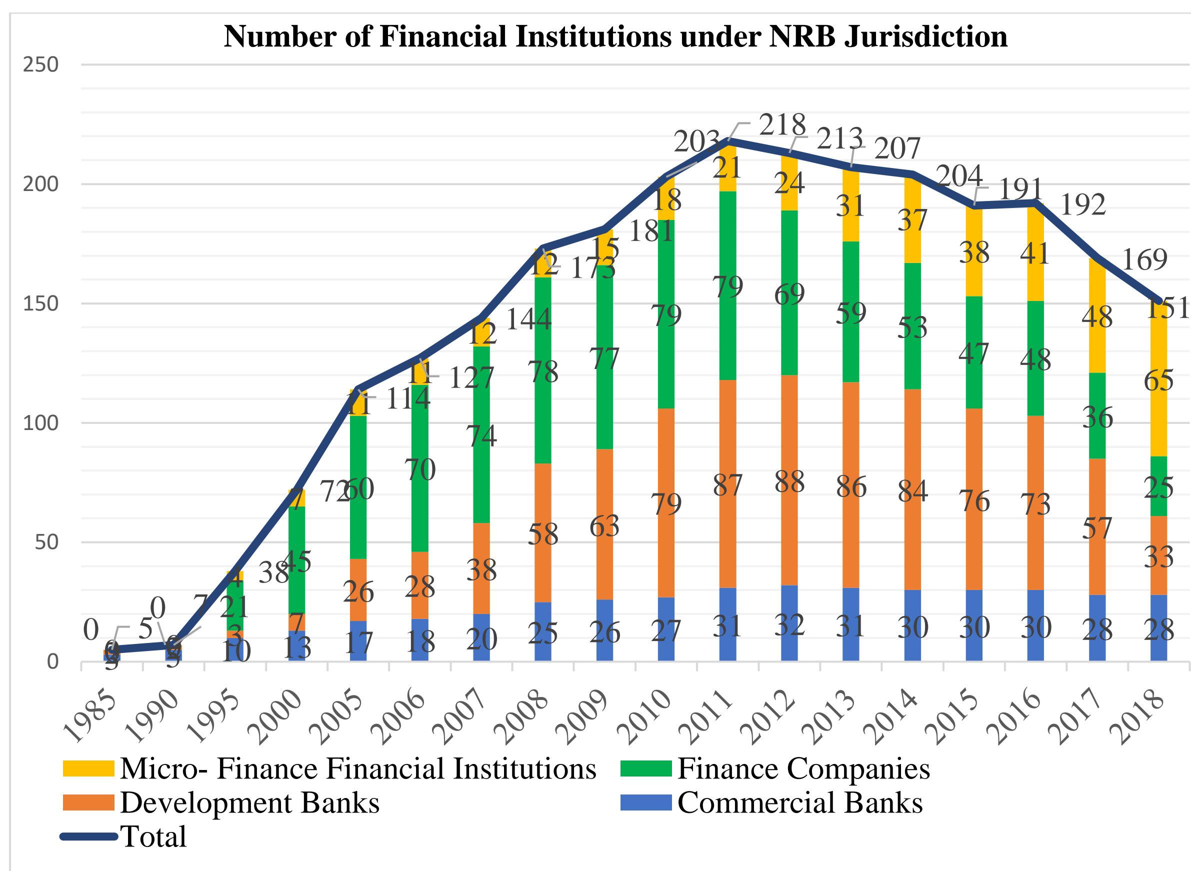

Figure 1-2: Number of Financial Institutions under NRB Jurisdictions 1985–2018

Source: Nepal Rastra Bank (2018)

The Rastra Bank classification that regulates BFIs in Nepal is based on their capital base, geographical coverage and operations (BAFIA 2017; Uprety 2013). There are four categories of BFIs in Nepal: class 'A' recognised as commercial banks, class 'B' known as development banks, class 'C' identified as finance companies, and class 'D' known as microfinance institutions (BAFIA 2017; Uprety 2013). Appendixes 1-1 and 1-3, show the different types of banks and financial institutions operating in Nepal. With respect to the BFIs' operations, as per the Nepal Rastra Bank Act 2002, class 'A' institutions are permitted to conduct a wide range of banking and financial services, such as corporate lending through consortium financing and conducting all types of foreign exchange operations. Development banks, however, are not allowed to engage in corporate lending through consortium financing; they are restricted to some foreign exchange operations such as letter of credit (LC) transactions and bills of exchange (BAFIA 2017; Uprety 2013). In the Nepalese financial market, therefore, commercial banks are usually more complex than other types of financial institutions, such as development banks and finance companies (Bank Supervision Department 2018).

As stated above in the Appendixes and figure, while there are several players in the Nepalese financial system, commercial banks are usually larger and more complex than the other BFIs (Bank Supervision Department 2018). Chapter 3 further explains the categories of Nepalese commercial banks. A list of commercial banks operating in Nepal is also presented in Appendix 1-3. Apart from the minimum paid-up capital requirement, geographical coverage and operational function, Nepalese commercial banks are also dominant in terms of their assets holdings. For example, in the Nepalese financial system, commercial banks occupy 83.41% in terms of the total assets and liabilities of NRB regulated BFIs (Bank Supervision Department 2018). This dominance of commercial banks can reveal that commercial banks in Nepal are the most important player of the Nepalese financial industry, exerting a significant role in the country's economy and development. The failure of even a single class 'A' bank could have a contagious effect on not just the entire Nepalese financial system but the whole economy (Bank Supervision Department 2018).

The above overview of Nepal's financial system clearly shows that the system's participation and integration into the global financial market has been growing in recent years. This expansion of the domestic financial system across national borders, however, has not only opened and broadened the opportunities for the Nepalese domestic financial market but has also increased its risk exposures to the global financial market. In other words, the risks of the

Nepalese financial system, which had been relatively confined to national boundaries (Nepal Rastra Bank 2018), is now directly exposed to global financial markets.

1.4 Research Gap and Contribution

The importance and scope of corporate governance are increasing. McNulty, Zattoni and Douglas (2013) claim that, since the 1990s, the number of qualitative studies in the field of governance has grown. There is, however, still only a limited number of published qualitative studies on governance (McNulty, Zattoni & Douglas 2013; Zattoni, Douglas & Judge 2013). Yasin, Muhamad and Sulaiman (2014) confirm that qualitative research in the field of corporate governance is understudied, despite there being diverse and extensive quantitative literature available. Bansal (2013) views that, in the corporate governance field, research tilts heavily in the quantitative direction. Aebi, Sabato and Schmid (2012), and Dupire and Slagmulder (2019) also claim that, despite the importance of risk governance in the financial sector, this topic has been little explored in the academic field. According to McNulty, Zattoni and Douglas (2013), there is a need and scope for qualitative research across different contexts and levels of analysis that explores corporate governance. Thus, there is much scope and need for qualitative research studies in this field (McNulty, Zattoni & Douglas 2013; Yasin, Muhamad & Sulaiman 2014; Zattoni, Douglas & Judge 2013).

In particular, Zattoni, Douglas and Judge (2013) have encouraged governance scholars to conduct qualitative governance studies from non-European countries, because prior research on governance was mostly based on the United Kingdom (UK) and European countries (McNulty, Zattoni & Douglas 2013; Zattoni, Douglas & Judge 2013). McNulty, Zattoni and Douglas (2013) found that four studies have been conducted in the United States of America (USA), one in Canada, three in China, two in the Middle East and one in Africa. The findings from the study of McNulty, Zattoni and Douglas (2013) indicate that qualitative governance studies have not been much explored in other research settings. Yusof (2016) agrees that prior studies in corporate governance have mirrored the US and UK contexts. In the Nepalese context, specifically, there have been limited research studies conducted in the areas of governance. For instance, Sharma (2014) claims that there have been no studies conducted in the Nepalese context in the area of corporate governance disclosures. Similarly, Acharya (2018) claims that very few studies have been conducted in Nepalese corporate governance and firm performance. From the above argument, it follows that there is both need and scope for qualitative corporate governance studies in the Nepalese context. Therefore, in investigating

the risk governance of the Nepalese commercial banks, this project aims to contribute broadly into two aspects.

First, as discussed earlier, this project adds to the existing literature because the topic of corporate governance has been less explored and studied in the Nepalese context. This project thus contributes to the extant risk management and corporate governance literature within the context of the Nepalese banking industry. Because this project studies the risk management practices of the Nepalese banking industry in relation to the Basel's corporate governance accords, this study can help stakeholders – such as researchers, investors, bank employees, customers and shareholders – understand the implementation of the Basel Accords in the Nepalese banking industry, especially the corporate governance mechanism for risk management.

Second, the findings from this project can contribute to policy debates. McNulty, Zattoni and Douglas (2013), and Zattoni, Douglas and Judge (2013) view that qualitative research is suitable to better understand and rethink corporate governance, as well as to assist policymakers and practitioners in formulating better governance mechanisms. To be precise, this study's results can indicate the need to call for policy actions. For example, stakeholders such as individual banks, banking associations, regulators and policymakers can call for actions to amend or improve policies and regulations, which will further strengthen the risk governance practices of Nepalese commercial banks.

1.5 Objectives of the Study

This project's primary purpose is to contribute to knowledge in the field of corporate governance for the Nepalese banking system by exploring and describing the risk management practices of the Nepalese commercial banks in particular. This project has not analysed the relationship between banking regulations and supervision on the banks' risk governance mechanisms. Similarly, this project has not examined the impact of banking regulations and supervision on the banks' risk governance mechanism. To achieve this project's objectives, the following research questions have been formulated.

Research Question 1:

How has the NRB implementation of the Basel's core principles helped the Nepalese commercial industry to progress its risk governance practices, precisely, the risk committee at board level and the CRO at the senior management level?

***Research Question 2*:**

Have Nepalese commercial banks complied with the risk governance structure mandates required by the Rastra Bank, precisely, for the risk committees at board level and the CRO at senior management level?

To achieve these objectives, two steps of analysis have been undertaken, which are explained in Chapter 3.

1.6 Thesis Outline

The remainder of this thesis is structured as follows. Chapter 2 comprises a relevant literature review, which discusses risk and risk management–related corporate governance mechanisms. Chapter 3 describes and discusses the data and methodology employed in this project. Chapter 4 presents and discusses the results, and Chapter 5 presents the study's conclusions.

1.7 Conclusion

This chapter started with an introduction that discussed the importance of risk management and its regulation in the banking industry. To contextualise this project, it gave a brief summary of Nepal and the Nepalese financial system. Chapter 1 also highlighted how this study can contribute to the extant literatures in the risk governance field to gain a better understanding of the risk governance mechanism in the Nepalese banking industry. This chapter also established the nature and structure of this study. The following chapter provides definitions for the key terms associated with risk governance, and it reviews the literature on the corporate governance mechanism for risk management.

CHAPTER 2 LITERATURE REVIEW

2.1 Introduction

In banking, the importance of risk governance has been increasing. Banking regulators are revising their risk management regulations and standards in an attempt to enhance the resilience of the risk management system. Within this context, the chapter provides definitions for the key terms associated with risk governance, and it reviews the literature on the corporate governance mechanism for risk management. This chapter also discusses the rationale for applying the theoretical approach taken in this study to answer the research questions identified in Chapter 1. This chapter contains 13 sections. The first six sections discuss several key concepts in risk governance, while the remaining sections review the literature relevant to this project. In particular, Section 2.2 provides an overview of banking; Section 2.3 explains the meaning and type of risk in banking, and Section 2.4 describes risk management and its importance on banking. Section 2.5 introduces the regulation of banks regarding risk management and further explains why regulations are essential in the banking sector. Section 2.6 explains the relationship between risk governance and the GFC. Section 2.7 provides a discussion of both the international and national regulations that guide risk governance in banking. Section 2.8 discusses the scope of risk governance. Section 2.9 shows what risk governance elements were investigated in the previous studies of risk governance. Section 2.10 gives a synopsis of some of the risk governance shortcomings of the Nepalese banking industry. Section 2.11 provides the rationale for choosing the agency and public interest theories to understand the risk governance mechanism of the Nepalese commercial banks. Section 2.12 summarises the literature to relate them with this project's research questions. Finally, Section 2.13 provides a review of this chapter.

2.2 Overview of Banking

In any country, banks are an essential industry, which offers a diverse range of financial services to their customers. Apostolik, Donohue and Went (2009) note that banks and banking have in existence for a long time. Traditionally, banks have offered core banking functions such as collecting deposits, underwriting loans and managing payment services (Apostolik,

Donohue & Went 2009). For example, banks act as an intermediary to mobilise funds between savers and borrowers (Das 2016) and to invest short-term liabilities in risky longer-term assets (Khalid & Hanif 2005). Similarly, banks deliver essential services to individuals, industries and governments (Keefe & Pfleiderer 2012) to finance their consumption, investment and capital expenditure need, respectively (Ozili & Outa 2017; Schwert 2018). By providing a financing source to businesses and consumers, banks play a critical role in facilitating the economic activities and economic development of a country.

In addition to these services, banks manage the transfer and payment of funds between parties, both locally and internationally (Apostolik, Donohue & Went 2009). Banks also facilitate economic activities through financial intermediation, assets transformation and money creation (Apostolik, Donohue & Went 2009). However, as banking evolves, the traditional functions of banks are extending. Choudhry (2011) views that the scope of the banking business is expanding in modern days. For instance, banks engage in a wide range of activities, from essential corporate lending to complex transactions such as securitisation and hybrid product trading (Choudhry 2011). Banks also now provide other financial services such as LCs, derivatives services and securitisation (Apostolik, Donohue & Went 2009). Each of these banking activities, however, generates more than one type of risk (Ghosh 2012). Thus, banks are specialised institutions that are engaged heavily in capitalist activities (Bhattacharya 2010; Watkins 2011) where these banking activities carry risks (Bhattacharya 2010; Ghosh 2012).

2.3 Definition of Risk and Types of Risk in Banking

The above overview of banking outlined that, in all banking activities, risks are inevitable. Because risks are omnipresent in banking, the following section explains the meaning and types of risk in banking.

2.3.1 Meaning of Risk in Banking

There are multiple definitions for risk (Apostolik, Donohue & Went 2009; Bessis 2011, 2015). The meaning of risk changes, depending on the context and its interpretation (Laycock 2014). The critical question is, therefore, how is risk defined in BFIs? Bessis (2011, 2015) defines risks in finance as the randomness of return on investment that includes both positive and negative outcome. In this sense, risks are related to the uncertainty and volatility of future outcomes. In the financial industry, however, risk is defined as uncertainty that can have

adverse consequences in the earnings or wealth of banks (Bessis 2011, 2015). In short, risk is 'the uncertainty of loss' (Onyiriuba 2016), and it has two main characteristics: uncertainty and loss (Onyiriuba 2016).

2.3.2 Types of Risk in Banking

All businesses, irrespective of their sector, face one kind of risk or another in their day-to-day operations. According to Crouhy, Galai and Mark (2014), non-financial institutions face traditional risks due to factors such as the entrance of new competitors, change in technologies, and weaknesses in supply chains. However, compared to non-financial institutions, BFIs are more exposed to different types of risks. Bhattacharya (2010) states that banks face both financial and non-financial risks. According to Ghosh (2012), while financial risks directly cause losses to the financial position of BFIs, non-financial risks affect their financial conditions indirectly. According to Bessis (2011), financial risks in BFIs can be differentiated as per the sources of losses, such as default on payment obligations by borrowers, internal fraud by staff and market movements. Thus, the broad types of inevitable financial risks in banking are credit, operational and market risks (Ghosh 2012). Likewise, the broad types of non-financial risks in banking are reputational, technology and legal risks. Figure 2.1 illustrates the different types of risks in banking, which are inevitable because of their business nature.

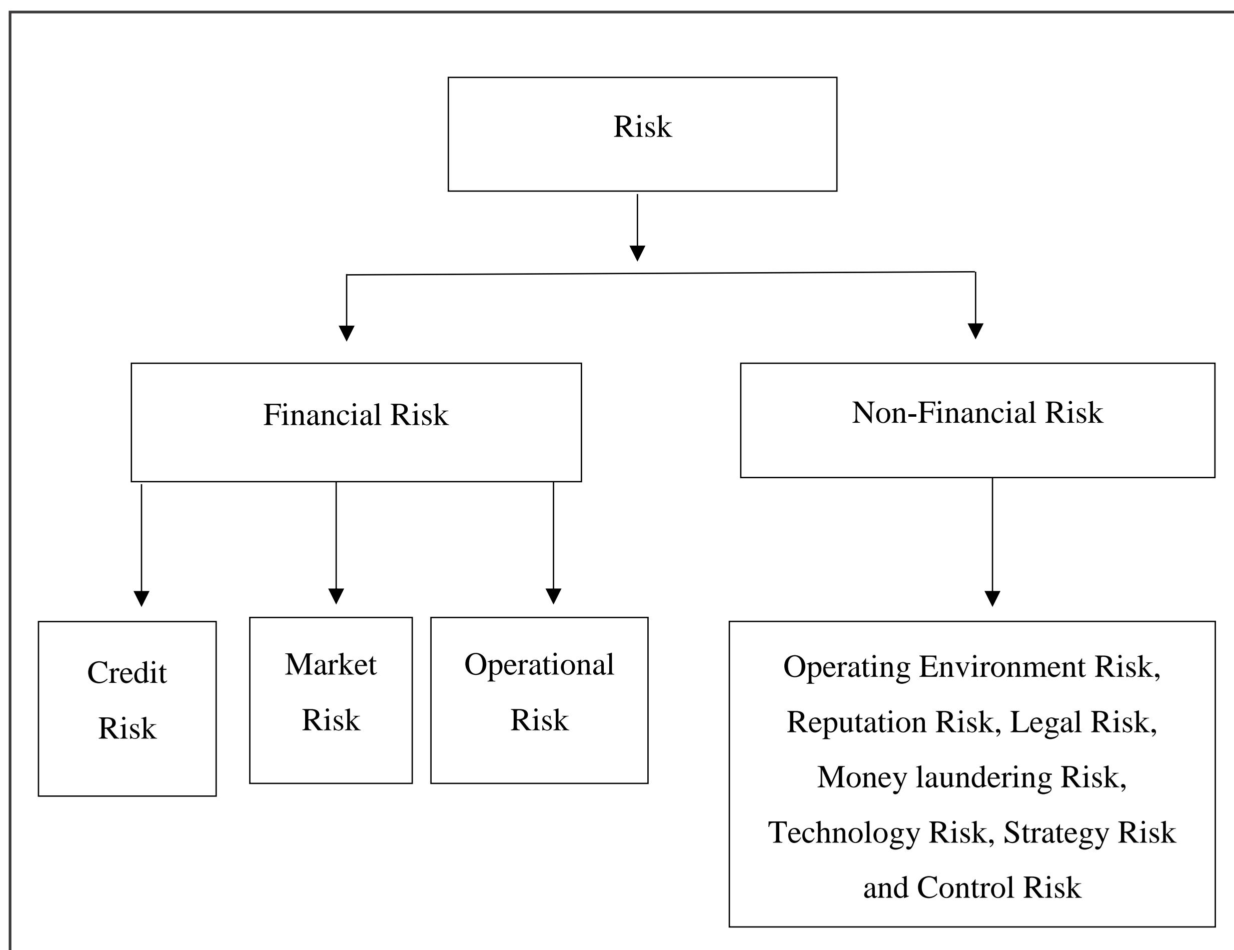

Figure 2-1: Types of Risks in Banking

Source: Ghosh (2012)

2.4 Overview of Risk Management in Banking and Its Importance

The above sections gave an overview of banking and risk, as well as the types of risks that banks face, and explained that banking is the risky business of money (Docherty & Viort 2014). They also explained that these risks are not only inevitable but also highly interconnected (Bhattacharya 2010; Crouhy, Galai & Mark 2014). Thus, risk management is a crucial function in banking. The following section describes the meaning and goal of risk management in banking and explains why risk management is crucial in banking.

2.4.1 Definition of Risk Management in Banking

Because risk management is a crucial function in banking, it is necessary to understand how risk management in banking is defined. According to Crouhy, Galai and Mark (2014), risk

management is the process of proactively selecting the type and level of risks that are appropriate for firms. This process includes the development of tools and techniques to identify and measure the risk, and to establish procedures and systems to manage those identified risks (Ghosh 2012). Robust risk management should define who is accountable for what risks and how risk processes are implemented (Bessis 2015). Risk management and risk-taking, therefore, are two sides of the same coin (Crouhy, Galai & Mark 2014). Further, in banking, risk management does not avoid or eliminate risks; rather, it handles them appropriately to minimise losses that might incur (Ghosh 2012). In short, risk management is the process where the risks to BFIs are identified, assessed and controlled (Bessis 2015) to optimise the risk-adjusted returns on assets (Ghosh 2012). Risk management in firms consists of the following steps, as shown in Figure 2.2, below.

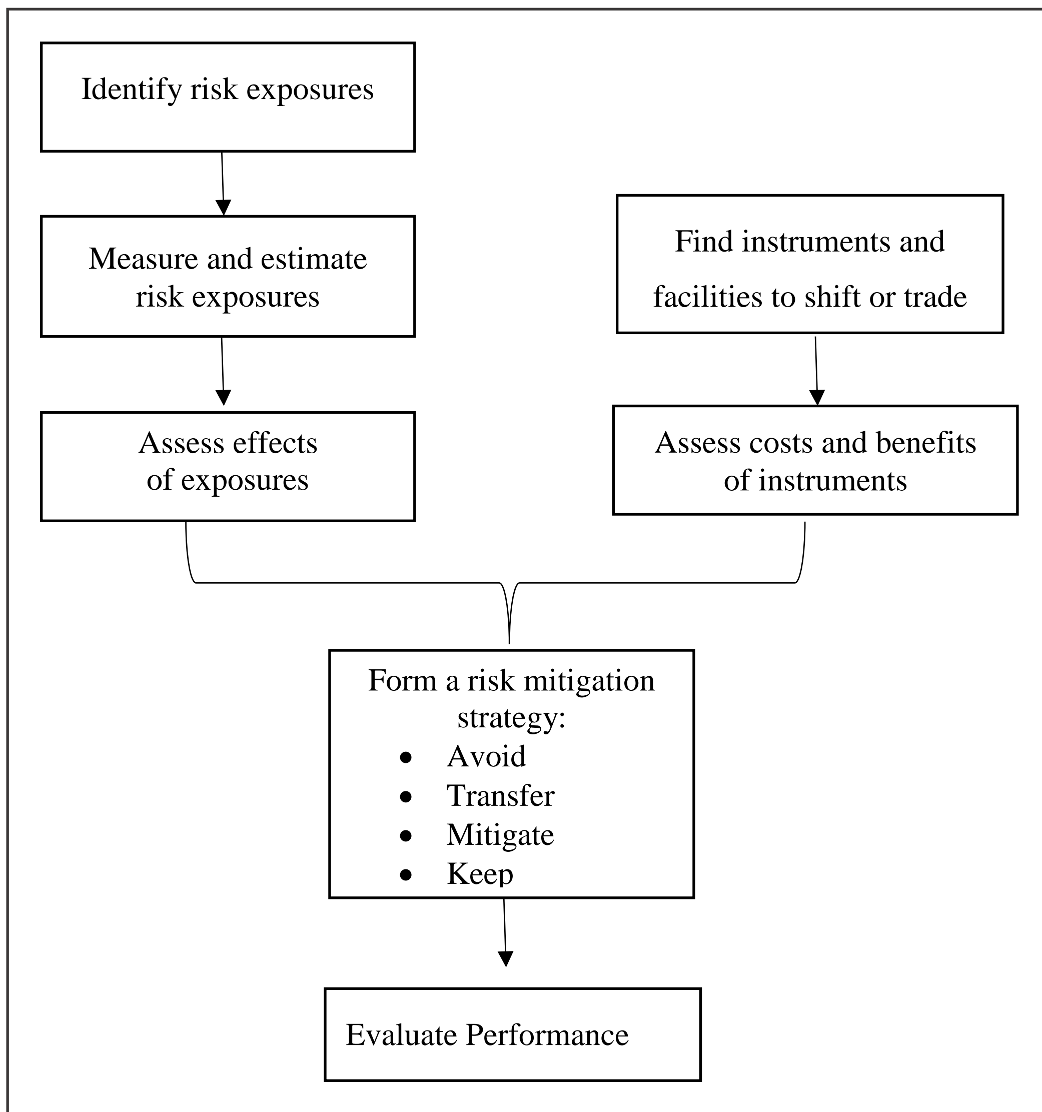

Figure 2-2: Risk Management Process

Source: Crouhy, Galai and Mark (2014, p. 2)

The above arguments about the definition of risk management showed that risk management has several goals. For instance, Bhattacharya (2010) states that one of the essential goals of risk management is to balance the optimal level of trade-off between risk and reward. Jimmy and Chen (2015) claim that, in banking, one of the goals of risk management is to find an efficient way to mitigate risk so that banks can have a tolerable risk profile. The main objective of risk management is to ensure the solvency of the banking entity, including its subsidiary groups (Ghosh 2012). In short, the main objective of risk management in banking is to balance the risks and returns of the banks, supporting the stability of the entire financial system and economy at large.

2.4.2 Importance of Risk Management in Banking

Risk management in banking is essential for several reasons. First, banks face a conflict of interest from multiple stakeholders. In the previous section's overview of banking, banks were found to have multiple stakeholders and exert significant impact to these stakeholders. However, these stakeholders also have their own interests in the banks. For instance, depositors want their deposit to be secured and readily available for withdrawal (Ghosh 2012). Likewise, shareholders demand a market return on their capital, and regulators strive for stability in the financial system and economy at large (Ghosh 2012). In this sense, BFIs such as banks are confronted simultaneously with the conflicting interest of stakeholders (Bessis 2015; John, De Masi & Paci 2016). For instance, banks are responsible for safeguarding the rights of their depositors; assuring the stability of the payment system; and, more importantly, reducing systemic risks (Andres & Vallelado 2008).

Second, BFIs such as banks are subject to the problem of moral hazard (Bessis 2015). Banks face the issue of moral hazard because they deal with the public's money (Haan & Vlahu 2016; Oates & Dias 2016). Moral hazard arises when the risk-taking party is more willing to take a risk because the cost of taking such risk will be borne by others (Bessis 2015). The primary obligation of banks is to create value for their shareholders, just like any other corporate firm (Jimmy & Chen 2015). Therefore, banks might not hesitate in taking excessive risks to fulfil this primary objective (Bhattacharya 2010). In other words, because BFIs deal with the public's money, there are both tendencies and opportunities to gain at the cost of depositors, especially by taking excessive risks (Haan & Vlahu 2016; Oates & Dias 2016).

The third reason for emphasising the importance of risk management in banking is because the failure of banks carries systemic risk (Apostolik & Donohue 2015). A bank failure, either partially or entirely, can have an adverse impact on the entire economy (Apostolik & Donohue 2015). In particular, a run on a bank can have an adversarial effect on the stability of the entire financial system and global economy at large (Crouhy, Galai & Mark 2014; Haan & Vlahu 2016; John, De Masi & Paci 2016). The failure of an individual bank not only harms its shareholders but also its depositors and other debtholders (Haan & Vlahu 2016; John, De Masi & Paci 2016). Thus, it is necessary for BFIs to protect depositors' interest and maintain financial stability because their failures can have severe adverse consequences in the economy (Bhattacharya 2010; Crouhy, Galai & Mark 2014; Jimmy & Chen 2015). Thus, the above discussions make clear why risk management is essential in the financial industry.

2.5 Corporate Governance and Risk Management

Most often, risk management interlinks with corporate governance. To illustrate this idea, the topic of corporate governance and risk management is highlighted whenever there are news stories about corporate scandals, corporate failures or financial crises (Abdullah 2014). The following section defines corporate governance and discusses its relationship with risk management.

2.5.1 Meaning of Corporate Governance

Corporate governance is multidisciplinary and multidimensional. The meaning and scope of corporate governance differ, according to the discipline and perspective from which it is viewed (Turnbull 1997; Yusof 2016). According to some, the definition of corporate governance is ambiguous and is influenced by theories originating from different academic disciplines (Padgett 2012; Turnbull 1997; Yusof 2016). According to Tricker (2019), the idea and practice of corporate governance are ancient and as old as trade itself. Du Plessis et al. (2015) claim, however, that early attempts to define the term 'corporate governance' can be found in the UK's Cadbury Report 1992. Tricker (2019) claims that the Cadbury Report 1992 became a pioneer standard-setter for corporate governance, even though the report solely aimed to improve corporate governance in Britain (Hemraj 2002). While companies in the UK were never forced to comply with the Cadbury Report's codes, companies were obliged to explain to their shareholders why they diverged from the codes (Padgett 2012). The Cadbury Report 1992 is still acknowledged as the starting point for how companies should be managed (Du

Plessis et al. 2015). Since 1999, scholars broadly recognise OECD principles as a point of reference for developing corporate governance codes and practices (Bota-Avram & Rachisan 2013).

Tricker (2019) mentions that, according to the Cadbury Report 1992, corporate governance is defined as a system by which corporations are directed and controlled. According to Tricker (2019), the Cadbury Report explained that the board of directors should be responsible for the governance of their companies through corporate governance codes. More importantly, Tricker (2019) claims that the Cadbury Report also called for establishing an appropriate governance structure. The main aspects of corporate governance covered in the Cadbury Report 1992 included the board's responsibilities, their qualifications and audit committee (Hemraj 2002; Padgett 2012). Governance encompasses rules, processes and regulations that guide decision-making processes on a company's strategies and operations (Crittenden & Crittenden 2012). Thus, according to Tricker (2019), corporate governance is a mechanism of exercising power to ensure that corporate entities are managed effectively and efficiently in the right direction. In other words, the board is accountable for an organisation's decisions, behaviours and performances.

Du Plessis et al. (2015), however, view that the above definition of corporate governance is not sufficient or helpful with the addition of further strands of corporate governance. Further, Du Plessis et al. (2015) argue that corporate governance is a system of regulating and supervising the activities of corporate entities to balance the interests of all stakeholders to ensure a company's long-term sustainable growth. According to the Basel Committee on Banking Supervision (2015), corporate governance is a set of relationships between a company and its stakeholders, which provides the structure and means for achieving and monitoring the company's objectives. García-Sánchez and García-Meca (2018) also view that corporate governance provides the mechanism for setting a firm's structure to achieve objectives that serve the interests of both shareholders and the wider community. Ultimately, corporate governance is a mechanism aimed at improving a firm's economic efficiency, supporting the company's growth and boosting investors' confidence (García-Sánchez & García-Meca 2018).

Based on the above definitions, corporate governance involves aligning the interests of a company's stakeholders to reduce inefficiencies that arise from moral hazard and adverse selection. Conversely, corporate governance requires establishing a mechanism to monitor the

policies, decisions and actions of companies. Tricker (2019) argues, however, that corporate governance ideas, concepts and practices are evolving continually. From this evolving nature of corporate governance, it promptly follows that the definition of corporate governance will adjust accordingly to new challenges and insights (Du Plessis et al. 2015).

2.5.2 Relationship between Corporate Governance and Risk Management

Corporate governance and risk management are highly related. Crouhy, Galai and Mark (2014) claim that it is difficult to distinguish clearly between risk management and corporate governance. From the view of corporate governance, the board's primary responsibility is to manage conflict of interest between stakeholders to boost returns, while assuming the risks and longer-term interests of all stakeholders in the company (Crouhy, Galai & Mark 2014). Khalid and Hanif (2005) state that strong corporate governance is the means for empowering banks' management to identify proactively, measure, monitor, and control the risk. Therefore, from the Sections 2.3.1 'meaning of risk management' and 2.5.2 'corporate governance', it promptly follows that the principles of both risk management and corporate governance are to increase the competitiveness of the organisations.

Many scholars have also discussed the importance of corporate governance as a means of risk management tool. Choi (2013) states that risk governance provides the framework to define which risks should be managed; who should be held accountable for managing a particular risk; and how should these risks be managed for creating shareholders' wealth, without risking the firm. Chen and Lin (2016) agree that corporate governance can help to manage and reduce banking risks. Similarly, according to Stulz (2016), good governance means that a bank has a mechanism that supports the board and management to choose the right amount of risk for its shareholders, which maximises their wealth. In short, all these arguments have illustrated that risk management and corporate governance are interrelated. The terms corporate governance and risk governance, therefore, are used interchangeably in this project.

Corporate governance is thus a set of relationships between a company and its stakeholders, which provides the structure and means for achieving and monitoring the company's objectives (Basel Committee on Banking Supervision 2015). These arguments explain how strong corporate governance is the means for empowering a bank's management to identify, measure, monitor and control risk proactively (Basel Committee on Banking Supervision 2015).

2.6 Risk Governance and the Global Financial Crisis

As mentioned earlier, corporate governance is evolving continually to incorporate new challenges and insights. For instance, to address flaws that were revealed during the GFC, the Basel Committee issued the Basel III (Anginer et al. 2019; Apostolik & Donohue 2015; McCracken et al. 2017). Tricker (2019) claims that the GFC caused some new components in corporate governance policies and practices to be added.

International standard-setting bodies and governance scholars have examined how risk governance could impact the ability of a bank to measure and manage risks for the bank's success. For example, the OECD (2009) states that one of the greatest shocks revealed by the GFC was widespread risk management failure across both financial and non-financial corporations. The OECD (2009) found that, in several events, the boards of corporations were ignorant of the risks to which the companies were exposed. According to the FSB (2013), corporations did not understand the risks to which they were exposed and that they were undertaking. The FSB (2013) also claims that directors had not given enough attention and time to set-up effective risk management structures, such as establishing a dedicated risk management committee (RMC).

In addition to the international standard-setting agencies mentioned above, several governance scholars have examined and revealed that weakness in risk governance was one of the main causes for the GFC of 2008. Kirkpatrick (2009) attributed the cause of the financial crisis to weakness in corporate governance, especially, failure to safeguard excessive risk-taking behaviours in financial corporations. Mongiardino and Plath (2010) argue that the failure of board members to oversee risks properly was one of the factors that contributed to the financial crisis. Murphy (2011) also claims that past crises and potential future failures of financial institutions can be attributed to risk management, which is linked to the mechanism of corporate governance. Abdullah (2014) points out that the enormous losses and corporate failures observed in recent years were due to excessive risk-taking by management. Dupire and Slagmulder (2019) also state that weaknesses in the governance and risk management functions of banks triggered the financial crisis. In short, especially after the financial crisis, corporate scandals that arise from practices, such as accounting frauds and lack of board accountability, have gained renewed interest in corporate governance regulations and practices.

2.7 Regulations in Banking for Risk Management

In one way or another, every industry is regulated and controlled. Tricker (2019) views that all corporate organisations, whether private or public, profit- or nonprofit-oriented, must be governed by a governing body. Tricker (2019) further claims that, by enacting legislation, governments provide the mechanisms for facilitating, regulating and constraining the activities of corporations registered under their jurisdictions. However, compared to other sectors, the financial industry is the most heavily regulated industry (Docherty & Viort 2014; McCracken et al. 2017). Banking activities are subject to an extensive body of rules (Bessis 2015), and a range of regulations and controls (Choudhry 2011). More importantly, BFIs are subject to strict compliance for numerous government regulatory regimes (Apostolik, Donohue & Went 2009; Docherty & Viort 2014; McCracken et al. 2017). Some examples of banking regulations are the minimum regulatory requirement of a bank's capital; compliance to features of corporate banking governance, such as board composition; and the qualifications and skills posed by the board of directors (John, De Masi & Paci 2016). The banking and financial regulators can impose similar types of regulations to those mentioned above for enhancing supervision and fostering financial stability (John, De Masi & Paci 2016).

All governments regulate the banking industry (Apostolik & Donohue 2015). They do so for various reasons. According to Crouhy, Galai and Mark (2014), there are mostly two reasons why regulators impose and monitor risk management standards. First, banks collect deposits from the public, and second, banks play a critical role in managing payments and facilitating the credit system (Crouhy, Galai & Mark 2014). The chief concern for all stakeholders, including bank regulators and authorities in charge of managing the economy, is to avoid a bank run (Apostolik & Donohue 2015). The regulators want to ensure that each bank operates fairly, responsibly and prudently (Apostolik & Donohue 2015; Jimmy & Chen 2015). They also want to ensure that the entire banking system remains stable (Jimmy & Chen 2015). As such, regulators closely monitor the activities of banks and require strict compliance from them for regulations such as minimum regulatory capital adequacy. One of the crucial purposes of bank regulation, in this sense, is to ensure that a bank keeps enough capital for the risks it takes (Hull 2012). From the above discussion, banking regulations can be understood as the most effective means of preventing systemic risks (Bessis 2015), by protecting depositors' interests and promoting the financial system's stability (John, De Masi & Paci 2016).

2.7.1 International Risk Management Framework for BFIs

Until 1988, banking regulation differed widely among countries, because different governments and regulatory bodies developed banking rules and supervisory guidelines that meet their own country's specific needs (Apostolik & Donohue 2015; Uprety 2013). The GFC, however, has illustrated that there is a need for an international approach to address specific types of regulatory problems. To illustrate, McCracken et al. (2017) view that system risks cannot be addressed through national regulations alone. Thus, international collaborations and frameworks are essential. The types of literature on the Basel are vast and complex (Docherty & Viort 2014). The following section briefly discusses the BIS, BCBS and Basel Accords, as related to risk management.

2.7.1.1 Bank for International Settlements and Basel Committee on Banking Supervision

McCracken et al. (2017) state that international bodies are essential in financial regulations. Various international bodies are involved in creating international financial regulations. For instance, G-20 and FSB are seen as agenda-setting bodies (McCracken et al. 2017). Similarly, the BCBS and International Organization of Securities Commissions (IOSCO) are considered as standard-setting bodies (McCracken et al. 2017). In 1930, central banks of G-10 set up the BIS based in Basel, Switzerland (Docherty & Viort 2014; McCracken et al. 2017; Scott & Gelpern 2016). Also referred to as the Basel, the BIS is the principal centre of cooperation for international central banks (Apostolik & Donohue 2015); (Docherty & Viort 2014; McCracken et al. 2017). The BIS fosters cooperation among central banks and other government authorities, which work in pursuit of monetary and financial stability (Pelzer 2013).

The BCBS, commonly referred to as the Basel Committee, functions under the supervision of the BIS (Boora and Kavita 2018) and is not a global supervisory authority (Apostolik & Donohue 2015; Pelzer 2013). The Basel Committee serves as an international cooperation forum (Apostolik & Donohue 2015), which helps shape banking regulations (Bhattacharya 2010). It provides a forum for supervisory bodies to exchange their experience on how to further improve efficiency and transparency in the banking industry (Lessambo 2013). The Basel Committee lacks the legal authority to enforce the recommendations and guidelines that it makes (Apostolik & Donohue 2015; Pelzer 2013).

2.7.1.2 The Basel Accords

The Basel Committee formulates and releases broad supervisory standards for the prudential supervision of the banking industry, commonly known as the Basel Accords (Boora & Kavita 2018; Lessambo 2013; McCracken et al. 2017; Scott & Gelpern 2016). The Basel Accords are international regulatory frameworks that govern the activities of banks (Apostolik, Donohue & Went 2009), which intends to align banking risks (Bhattacharya 2010) through the Basel Capital Accords. While the Basel Accords are neither a treaty (Scott & Gelpern 2016) nor regulations (Apostolik & Donohue 2015), they are followed worldwide by banking and financial regulators, both in developing and developed countries (Boora & Kavita 2018; Pelzer 2013).

The Basel Accords serves as an international banking standard for regulations and supervision of banking (Apostolik & Donohue 2015; Lessambo 2013). These Basel norms provide a structured approach, facilitating banking and financial regulators and supervisors, and identifying banking to identify risks (Apostolik & Donohue 2015). In addition, the Basel Accords provide a structured approach to link these identified risks directly with banks' capital (Apostolik & Donohue 2015). The Basel Accords thus provide a standard for mitigating the risks inherent to banking business (Apostolik, Donohue & Went 2009). In short, they serve as international regulatory standards and protocols for identifying and mitigating the risks inherent to banking business (Lessambo 2013; Apostolik & Donohue 2015). The Basel III Accords have been considered as international banking regulations, providing an opportunity for strengthening the risk management system in the banking industry (Boora & Kavita 2018). Specifically, adopting international capital standards and the *Basel Core Principles for Effective Bank Supervision* (BCP) are key protocols to risk management (Ayadi et al. 2016). However, one of the most important aspects in understanding the Basel Accords is that financial rules issued by the Basel Committee are generally 'soft-law' (McCracken et al. 2017). These are rules that have non-binding agreements (McCracken et al. 2017).

The three Accords issued by the Basel Committee are the Basel I, II and III. A discussion of these three evolving Accords is beyond the scope of this project. However, all three of the Basel Accords are closely related to each other (Apostolik & Donohue 2015) and reflect recent developments in the financial industry (Apostolik & Donohue 2015). For instance, the three Basel Accords recognise that a bank's inherent risks are related to the bank's capital (Apostolik & Donohue 2015). The Basel Accords also support that maintaining adequate high-level bank

capital alone is not sufficient to ensure financial stability (Apostolik & Donohue 2015). Thus, these Accords help banks, as well as banking and financial regulators and supervisors, to mitigate their risks (Apostolik & Donohue 2015; Lessambo 2013; McCracken et al. 2017).

2.7.2 Legal Architectures of Banking in Nepal

Generally, BFIs are subject to the regulatory requirements of their domestic banking and financial regulators. Governments legislate different Acts and Laws for facilitating, regulating and constraining the activities of corporations registered under their jurisdictions, while banks are subject to the country's common law; there are Acts, laws and regulations that govern the behaviours of BFIs. Within the context of the Nepalese financial system, all BFIs are incorporated as public limited companies under the Company Act (Nepal Rastra Bank 2018). The banking and financial sector of Nepal is regulated by various Acts, regulations, Bylaws; accordingly, regulators regulate different sectors of the financial system. For instance, the Central Bank of Nepal, Nepal Rastra Bank, is both the regulator and supervisor of BFIs (Bank Supervision Department 2018). Another independent regulator of non-banking sectors is the Securities Board of Nepal (SEBON), which regulates the security market (Bank Supervision Department 2018). Contractual saving institutions, such as Employee Provident Fund (EPF) and Citizen Investment Trust (CIT), operate under the regulatory jurisdiction of the Ministry of Finance (Bank Supervision Department 2018). Similarly, the Insurance Board (IB) regulates insurance companies (Bank Supervision Department 2018). Thus, the Nepalese financial system has multiple sectors, which are regulated by more than one regulating body. Because this project aims to explore about the risk management of commercial banks, its focus is the banking system in Nepal, and the Acts, rules and Bylaws that regulate and govern the operations of commercial banks. The following section covers the legal architectures of the Nepalese banking sector.

2.7.2.1 The Nepal Rastra Bank

While the formal modern banking system commenced in Nepal in 1937 (Gajurel & Pradhan 2012), the Central Bank of Nepal came into existence only in 1956 (Gajurel & Pradhan 2012). The Nepal Rastra Bank was established as Central Bank in Nepal, under the Nepal Rastra Bank Act 1955, to carry out the functions of a central bank. The NRB mostly regulates and supervises commercial banks, development banks, finance companies, microfinance institutions, FINGOs and cooperatives, carrying out limited banking activities (Bank Supervision Department 2018).

As a regulator and supervisor of BFIs in Nepal, the NRB is responsible for maintaining the safety, stability and soundness of individual banks as well as the overall banking system (Bank Supervision Department 2018). The role of the Rastra Bank will be discussed further in Chapter 4.

2.7.2.2 Regulatory Frameworks

Various legislative provisions facilitate the NRB's regulatory and supervisory role. According to the Nepal Rastra Bank (2018), the legal architecture governing the Nepalese financial system is grouped broadly into three areas. The first category comprises the Acts that govern the Rastra Bank's functions (Nepal Rastra Bank 2018). The Nepal Rastra Bank Act falls under this category. The second category includes those Acts that govern the whole banking system, which is under the Rastra Bank's regulation (Nepal Rastra Bank 2018). Examples are BAFIA, Organized Crime Prevention Act 2013, Money (Asset) Laundering Prevention Act 2008, Banking Offence and Punishment Act 2008, and Banks and Financial Institutions Debt Recovery Act 2002 (Nepal Rastra Bank 2018). Some of these Acts are amended regularly to incorporate the changing economic and financial contexts. For instance, in 2015, the NRB made its second amendment to the Money (Asset) Laundering Prevention Act 2008 (Nepal Rastra Bank 2018). Similarly, the Banking Offence and Punishment Act 2008 was first amended in 2016 to expand the scope of banking offences to include cooperatives and 'Dhukuti'.

The third category includes rules, Bylaws and Directives, as well as guidelines that the NRB issues for the operation and regulation of the banking system, including its activities (Nepal Rastra Bank 2018). According to Nepal Rastra Bank (2018), the NRB issues prudential regulations and guidelines in the form of Directives. Directives play a crucial role in maintaining financial stability in the economy and helps to enhance public confidence in the financial system (Nepal Rastra Bank 2018).

A discussion on each of these legal architecture categories is beyond the scope of this project. From this section on regulatory frameworks, however, it can be understood that while the 'soft-laws' created by the Basel Committee are non-binding agreements, they influence the content of national regulations and the behaviour of regulators and market participants (McCracken et al. 2017). More importantly, it can be observed that, like other developed and developing economies, Nepal is legislating new regulations to direct the corporate activities, behaviours and systems.

2.8 Scope of Risk Governance

According to Tricker (2019), corporate governance focuses on a set of players including shareholders, the board of directors and management. However, risk governance is broad in its scope. The Basel Committee has emphasised the role of all staff in risk management explicitly, strengthening each section's accountability by clearly demarcating the board responsibilities for effective board oversight (Basel Committee on Banking Supervision 2015). For instance, the Committee's revision of 'Principles for Enhancing Corporate Governance 2010' specifically outlined the roles of boards, board-level risk committees and senior management in risk management, including the Chief Risk Officer (CRO) and audit department (Basel Committee on Banking Supervision 2015). Therefore, every staff member and each section of a bank has a different role in risk management. The following section elaborates on the accountability of the board and senior management.

2.8.1 Risk Governance at Board Level

Each person at all levels is responsible for risk management (Sheedy & Lubonjanski 2018). One of the most crucial questions, however, is who is, or who should be, ultimately responsible for the risk management of a company (Choi 2013). Haan and Vlahu (2016) state that shareholders appoint the board of directors to control the managers and to ensure that the firm is running in shareholders' interest. Thus, the boards are responsible for activities such as making decisions, creating value, and monitoring and advising management on the shareholders' behalf; therefore, the board of directors are accountable for the risk management function (Choi 2013). There is not one specific, universally accepted model or system for the risk governance mechanism, as every bank has different risk management policies and strategies to manage their risks (Chen & Lin 2016). Moreover, different categories of risks require unique risk management approaches (Kaplan & Mikes 2012).

There are different schools of thought as well as various practices on how risk oversight functions should be delegated, either to the entire board or through several board committees. Some have advocated that risk management responsibilities should be entrusted to the whole board, while others suggested that there should be an audit committee at board level to oversee the risk management processes. Sheedy and Lubojanski (2018) view that risk management is not the responsibility of senior management or risk specialists. Some believe that a stand-alone Board RMC should be accountable for risk oversight (Ittner & Keusch 2016). For instance, the

Basel Committee recommends establishing board-level committees for the boards' risk oversight role (Basel Committee on Banking Supervision 2015). Du Plessis et al. (2015) state that the major reason behind establishing several board committees is to assist the board in fulfilling their primary functions of directing and supervising management to achieve the company's objectives. The question that now arises in establishing board-level committees is: 'Will the risk management of BFIs become more efficient and effective with the establishment of risk management board sub-committees? The following section explains how the establishment and separation of risk committees can be essential to BFIs.

2.8.1.1 Is the Institutionalisation of Separate Risk Committees Necessary?

With the evolving risk oversight functions of boards, how should the risk governance of banks and financial institutions be instituted? How should the board of a bank structure itself, in terms of managing risks? What would guide the board's risk governance process? Who should be accountable for the bank's risk oversight function? Why there is a need for the separate institutionalisation of committees, such as audit and risk management committees, for the bank's risk oversight function? The need for the separate institutionalisation of committees, such as audit and risk committees, for risk oversight function is justified below.

First, in Gupta and Leech's (2014) view, the traditional audit approach of reporting to the board focuses on communicating about topics such as the effectiveness of internal controls, compliance to both internal policies and procedures, and external regulatory requirements. This traditional approach of communication does not contain sufficient breadth and depth of risk information that is essential for boards to discharge their fiduciary duties for risk oversight (Gupta & Leech 2014). Second, as explained by Ittner and Keusch (2016), an audit committee has a heavy workload in terms of preparing financial reports and assessing compliance requirements. Thus, the additional risk oversight role could only increase their already heavy workload. In other words, an audit committee would not be able to fulfil their risk governance role because they might be overwhelmed by the increasing requirements and complex financial reporting standards and internal controls (Choi 2013).

The audit committee's time, resources or expertise may be no longer enough to assess and manage the broad range of risks that an organisation is facing (Jaeger 2015). Choi (2013) also viewed the skills and expertise possessed by the audit committee as being different from that needed for the role of risk governance. For instance, the audit committee may require an additional number of people in the committee, as well as additional training and development

plans for their staff to carry out the additional risk management role. Thus, the resource constraints of the audit committee are the third reason that supports establishing a separate risk committee.

The fourth reason is that the board needs to have a prospective outlook for risk oversight (Murphy 2011). The board members should necessarily require prospective focus for approving business plans and strategies (Murphy 2011). However, as mentioned earlier, the audit committee usually has a retrospective outlook, and the risk management committee has both prospective and retrospective viewpoints (Murphy 2011). To balance both these outlook dimensions, a separate risk management committee is needed (Murphy 2011).

The differences in the roles of the risk management and audit committees, in terms of the board-level risk oversight role, are summarised in Appendix 2-1.

2.8.2 Risk Governance at Senior Management Level

With the evolution of risk oversight functions, how should senior management support the board of directors to discharge their risk oversight function effectively? How should the risk governance of banks and financial institutions be instituted? How should banks structure their management functions, in terms of managing the risks? What would guide the risk governance process of senior managers? How should they be accountable for the bank's risk oversight function?

Tricker (2019) claims that a crucial area in corporate governance is the relationship between senior management and the board. Tricker (2019) states that the board delegates some of its functions to their senior management. However, the company's freedom to delegate the board's responsibilities to senior management depends on their Article of Association and Memorandum of Association, and more importantly, the regulatory requirements (Tricker 2019). One of the mechanisms for delegating the board's risk oversight responsibilities to senior management is the appointment of the CRO.

According to Crouhy, Galai and Mark (2014), the GFC highlighted the need to re-empower the CRO's role. Several factors, such as independence, stature and resources, must be reviewed in terms of strengthening the CRO's authority. According to Crouhy, Galai and Mark (2014), the CRO should be placed at the senior management level within the organisational structure. One of the CRO's key roles as a committee member is to represent senior management at the board's risk management committee (Crouhy, Galai & Mark 2014). The key reason for appointing a

CRO at the senior level is to ensure that the CRO can act as a risk strategist (Crouhy, Galai & Mark 2014). As a risk strategist, the CRO not only provides an independent and strong voice to determine which risks banks should assume but, more importantly, helps to manage those risks (Crouhy, Galai & Mark 2014). Crouhy, Galai and Mark (2014) further state that the CRO should attend board meetings regularly. The CRO should also have a direct reporting line to either the board or its risk committee, along with reporting to the CEO and management committee (Crouhy, Galai & Mark 2014). This reporting line facilitates the CRO to communicate and inform the board and management committee about the risk policies, risk methodologies and other risk issues down through the organisation (Crouhy, Galai & Mark 2014). In other words, holding direct and regular meetings with the board and its risk committee allows the CRO to inform and report to the board and its risk committee regarding risks issues and exposures.

2.9 Previous Studies on Risk Management–Related Corporate Governance Mechanisms

The previous literature on risk governance has focused on examining externally observable risk governance mechanisms. For instance, Sheedy and Griffin (2018) confirm that prior research in the areas of risk management and corporate governance in banking has mostly investigated externally observable, risk management–related corporate governance mechanisms, such as the existence and structure of board-level and senior management–level committees responsible for risks management in the banks, along with the reporting line. Stulz (2016) agrees that prior risk governance literature has focused on determining whether or not a board has established its risk committee. Further, Stulz (2016) states that prior literature has focused on analysing how often these committees met, and in which areas did the members have expertise.

To elaborate, Aebi, Sabato and Schmid (2012), and Mongiardino and Plath (2010) investigated the presence of board-level committees accountable for risk issues, their frequency of meeting, and the risk committee's composition. Mongiardino and Plath (2010), and Aebi, Sabato and Schmid (2012), have also analysed the CRO's presence, reporting line and status in the organisational structure. Aebi, Sabato and Schmid (2012) analysed the existence of independent directors, directors' experience, and activities undertaken by the risk committees. Likewise, Murphy (2011) studied 25 banking companies to examine publicly disclosed corporate governance elements related to the risk management, such as audit function, risk management department and independence of the boards. The use of proxies – such as

existence of board-level committees, composition of these committees, frequency of committee meetings, and presence and reporting line of the CRO – however, do not in themselves guarantee strong risk management practices (Aebi, Sabato & Schmid 2012; Mongiardino & Plath 2010; Murphy 2011; Sheedy & Griffin 2018).

Similarly, there is no evidence that the presence of a dedicated risk committee influences the extent of a board's involvement in risk oversight (Ittner & Keusch 2016). Sheedy and Griffin (2018) shared similar views, arguing that the effectiveness of risk governance depends not only on the existence of structures and policies but in the way that those structures and policies are implemented. The existence of proxies of risk governance elements is a key ingredient, which forms the basis for sound risk management practices (Eckblad, Black & Ogunro 2015; Mongiardino & Plath 2010; Sheedy & Griffin 2018). Nahar, Jubb and Azim (2016) claim that forming risk committees is an effective means of making these committees ultimately accountable for managing risks, by constantly identifying, measuring and communicating, reporting and monitoring the risk profiles of the business; approving the bank's risk appetite; and formulating strategies for embracing risks. Therefore, these risk governance proxies can provide a sound base on which to build effective risk management.

2.10 Risk Governance–Related Weaknesses Identified in the Nepalese Banking System

The Bank Supervision Department (2017) claims that the Nepalese financial system has poor corporate governance. The practice of effective risk management is low in the Nepalese banking sector (Bank Supervision Department 2015), even though the NRB has issued Risk Management Guidelines that are based on the core Basel principles of setting standards for risk management (Bank Supervision Department 2015). The Post Report (cited in Sharma 2014) states that a Central Bank official has the opinion that there is 'bad corporate governance' in the Nepalese banking system, and that this poor corporate governance practice has been the largest problem for both individual banks and the system itself. The Bank Supervision Department, which carries out the supervision of commercial banks, has been pointing out this weakness in risk management and corporate governance issues since 2001. The Bank Supervision Department, which started publishing annual supervision reports in 2001–2002, has furnished information on violations of regulatory requirements by each commercial bank. However, from 2007 onwards, the Bank Supervision Department has provided this information only in a summary version of the overall banking system. From 2008, the Nepal Rastra Bank

also started to furnish its enforcement actions through a separate link on its website. The details of these enforcement actions are discussed further in Section 4.5.

Some of the breaches on risk governance practices discussed in the Bank Supervision Department's annual reports are demonstrated below. According to the Bank Supervision Department (2001–2002), Kumari Bank Limited and Himalayan Bank were not complying with NRB Directives regarding the appointment of the Banks' Chairmen. Similarly, promoters of Nepalese commercial banks influenced the banks' functioning, including the recruitment of staff and lending decisions (Bank Supervision Department 2002–2003). During its onsite examination of commercial banks in 2004/05, the Bank Supervision Department observed significant lapses in areas of corporate governance (Bank Supervision Department 2004–2005). Examples of such shortcomings include the CEO of Laxmi Bank Limited being a permanent invitee to the Audit Committee (Bank Supervision Department 2004–2005). This practice was against the provision of the Directive on corporate governance (Bank Supervision Department 2004–2005). In the same year, the Chairperson of Standard Chartered Bank Nepal Limited (SCB) was found to be a member of the Audit Committee (Bank Supervision Department 2004–2005). This practice was also not desirable for good corporate governance (Bank Supervision Department 2004–2005). Likewise, the director of Everest Bank Limited (EBL) was found to be involved directly in the bank's daily functioning (Bank Supervision Department 2004–2005).

In addition, EBL and Siddhartha Bank Limited did not comply with the number of meetings needing to be conducted by the board of directors (Bank Supervision Department 2004–2005). During the onsite examination, Siddhartha Bank Limited's director was found to be a member of the bank's Credit Committee and Audit Committee (Bank Supervision Department 2004–2005). Bank of Kathmandu Limited's internal audit department was responsible for NRB reporting and other tasks (Bank Supervision Department 2004–2005). The internal audit department of Bank of Kathmandu Limited was inadequate, in terms of the nature and volume of the bank's transactions (Bank Supervision Department 2004–2005). According to the Bank Supervision Department (2004–2005), the Board meeting minutes of Bank of Kathmandu Limited did not contain adequate information. The minutes were found to be in a much-summarised form (Bank Supervision Department 2004–2005). All these risk governance practices of commercial banks showed that banks were not complying with the provisions of corporate governance directives. It then follows that every Nepalese commercial bank, to some

extent, has shortcomings in the area of good corporate governance practices (Bank Supervision Department 2004–2005).

As stated earlier, the Bank Supervision Department started to publish annual supervision reports in 2001–2002. These annual reports furnished the detailed reports on commercial banks' risk governance practice until 2006. From 2007, however, the Bank Supervision Department has been furnishing only a summary of the banks' risk governance practices. During the onsite examination of commercial banks, discrepancies identified in the areas of corporate governance and risk management practices included lack of effectiveness of the audit committee and internal audit function, and independence of Directors (Bank Supervision Department 2007). The Bank Supervision Department (2019) claims that, in some banks, the risk management function is not independent of the business function. The Bank Supervision Department (2019) further claims that oversight by the board and senior management is not adequate.

In some cases, the same individual is responsible for both business and control functions (Bank Supervision Department 2019). This risk governance practice and system show that there is poor segregation of duties and responsibilities, which further hinders in ascertaining the necessary checks and balances. This inadequate segregation of duties and responsibilities also creates a conflict of interest for assigned roles. More importantly, the weaknesses identified in these risk management and corporate governance issues indicate that there are insufficient policies and procedures in place (Bank Supervision Department 2019). Adherence to these documents is not adequately monitored (Bank Supervision Department 2019). The above discussion on risk governance in the Nepalese banking industry reveals that, to some extent, every Nepalese commercial bank has shortcomings in the areas of good corporate governance practices. However, it also indicates that some of the weaknesses in risk management and corporate governance issues, which have been identified since 2001, are still in existence in the banking sector (Bank Supervision Department 2019).

2.11 Theoretical Framework for Corporate Governance

One of the essential building blocks in the research process, claims Losoncz (2017), is the theoretical rationale. Theoretical rationale provides a lens to look at the world and to make sense of what it means (Losoncz 2017). As mentioned in Section 2.5.1, corporate governance is diverse in meaning and scope and varies with the type of lens used to view it. Likewise,

corporate governance has drawn on varieties of theories from distinct academic disciplines (Padgett 2012), such as finance, accounting, management, law, sociology and economics (Zattoni & Van Ees 2012). Each of these academic fields offers a distinctive theoretical perspective on a company's governance (Padgett 2012). The 'basic theories in corporate governance emerged with the agency theory which extended into stewardship theory and stakeholder theory and evolved to resource dependency theory, political theory, legitimacy theory and social contract theory' (Yusoff & Alhaji 2012, p. 52). Borlea and Achim (2013, p. 117) also view that theories of corporate governance are rooted in agency theory, which later developed into stewardship theory and stakeholder theory, and further advanced into the theories of resource dependence, transaction cost, political, ethics, information asymmetry and efficient markets.

Any individual theory cannot best explain a practical and effective governance mechanism (Borlea & Achim 2013; Yusoff & Alhaji 2012). Further, there is no single corporate governance theory to pinpoint in the understanding of corporate governance mechanisms (Borlea & Achim 2013; Padgett 2012). Therefore, scholars are encouraged to apply a combination of existing corporate governance theories (Borlea & Achim 2013; Yusoff & Alhaji 2012). In line with the research questions developed in Chapter 1, this project used the agency and regulatory theories to understand the corporate governance mechanism of Nepal's commercial banks. The following section briefly explains each theory and the rationale for applying these theories to this project.

2.11.1 Public Interest Theory

Section 2.7, above, explained why banking is the most regulated industry worldwide. Section 2.7 also explained why compliance with various regulatory requirements is essential in the banking industry. Haines (2017) views that it is complicated to understand why and when some regulations are forthcoming. In such a context, finding a suitable theoretical framework helps to understand the regulations. Using an appropriate regulatory theoretical lens helps to understand why regulation is essential and how regulation is developed (Deegan 2016). Regulatory theories, such as public interest theory, capture theory and economic interest group theory of regulation (Deegan 2016), explain different perspectives on why and how regulations are introduced. *Public interest theory* views that regulations are initiated by the regulatory body to benefit society as a whole (Deegan 2016, p. 112). Other theorists of regulations, however, suggest that regulations are introduced to benefit some vested group of people at the expense

of others (Deegan 2016, p. 112). For instance, where policy is changing rapidly in corporate governance regulation (Padgett 2012), there are many motives for introducing corporate governance regulations. Particularly, regulators globally are converging corporate governance mechanisms as a part of learning from and adopting the best international practices, or as part of fulfilling a group's interest, such as investors' demands, pressure and encouragement for adopting good practices of corporate governance (Padgett 2012). Some examples of best international practices in corporate governance mechanisms are separation of the CEO and Chairperson's role in a company, and establishment of a board sub-committee for the effective functioning of the entire board (Padgett 2012).

Researchers who embrace *public interest theory* assume that a regulatory body is established to represent the wider interests of society and serve the public interest (Deegan 2016). For the public interest theorist, legislations are enacted to balance social benefits with social costs (Deegan 2016). For instance, while risk and regulation seem paradoxical to some extent, to reduce the vulnerability of a wide variety of risks to a tolerable level, risk and regulations are often combined (Haines 2017). Similarly, regulators globally wish to find out the best solutions to their corporate governance problems (Padgett 2012). This project has focused on analysing best international practices in the risk governance mechanism adopted by the Rastra Bank. Therefore, the use of *public interest theory* would be suitable for this project.

2.11.2 Agency Theory

Section 2.4.2, above, discussed how the risk management function in banking is unique compared to other firms, and why risk management is essential. Section 2.4.2 also discussed that banks face a conflict of interest from multiple stakeholders and are also subject to moral hazards. This line of discussion then asks the question, in whose interest should the companies be operated (Padgett 2012). Tricker (2019) views that, while corporate governance has numerous theoretical perspectives, it neither has a single widely accepted theoretical base nor a generally accepted paradigm (Tricker 2019). However, *agency theory* is being viewed as being synonymous of corporate governance theory (Lubatkin 2007). This theory assumes that shareholders are the principals of firms, the board of directors are the agents – and that the board of directors lead and make decisions in the shareholders' interest (Borlea & Achim 2013; Padgett 2012). In other words, *agency theory* views corporate governance as the mechanism to find an effective means of monitoring managers' actions to ensure that management acts on the shareholders' behalf (Padgett 2012).

From the *agency theory* perspective, the important entities in the corporate governance of a company are the shareholders, managers and board of directors (Tricker 2019). For instance, shareholders own the company; managers oversee the day-to-day activities, such as selecting and executing the firm's decisions; and the board of directors approve those decisions (García-Sánchez & García-Meca 2018). *Agency theory* assumes that to reduce moral hazards and harmonise the conflict of interest among different entities of the firm, the shareholders hold a unique place in the company's corporate governance mechanism (Padgett 2012). From the perspective of *agency theory* in corporate governance, shareholders can monitor management through the mechanisms of the board of directors and auditors (Padgett 2012). Shareholders appoint the board of directors to control managers' behaviours and to ensure that the firm is running in the shareholders' interest (Haan & Vlahu 2016). The board of directors is responsible for monitoring and controlling managerial decision-making to protect the shareholders' interest (Yusoff & Alhaji 2012). Therefore, the board of directors appointed by shareholders owes their fiduciary duty to the shareholders (Padgett 2012).

This project has focused on analysing the different risk governance mechanisms of the Nepalese banking sector, such as at the board and senior management levels. *Agency theory* assumes that corporate governance is the mechanism to find an effective means of monitoring the managers' actions to ensure that they act on the shareholders' behalf. Based on these arguments, applying *agency theory* in this project would be appropriate to understand the roles of the board of directors and senior management level in the banks' risk oversight function.

2.12 Summary of Literatures and Its Implication for Research Questions

The above sections have assisted in understanding why risk governance is essential in the banking industry. The above sections also highlighted how risk regulations at both national and international level support in building robust governance structures. This project has investigated the risk governance features that are similar to previous studies (Aebi, Sabato & Schmid 2012; Ittner & Keusch 2016; Mongiardino & Plath 2010; Murphy 2011). This project differs from these studies mentioned above, however, because this research investigation focuses on analysing the risk governance features within the context of the Nepalese banking industry. In the first stage, this research project attempts to explore in what way the NRB has adopted the Basel Accords, relating to the board and senior management risk oversight function. By comparing and contrasting the principles and mechanisms of the board and senior

management of the NRB requirements against the Basel Accords, the project aims to identify whether or not the NRB has implemented the Basel Principles with the same motivation.

In the second stage, this project analyses whether the sample banks are complying with their regulatory requirements, in terms of the board and senior management's roles for risk oversight. It compares risk governance structures across the sample commercial banks to assess their compliance with regulatory requirements. The results of this comparison help to gain insights into whether or not the commercial banks across Nepal have similar board-level committees and senior management for overseeing the banks' risks. Thus, this project explores the NRB's implementation of the Basel Accords by considering the risk management–related corporate governance that has been investigated by previous risk governance scholars.

2.13 Conclusion

This chapter discussed the relevant concepts and literature in risk governance. It showed that risk management practices are essential functions in both financial and non-financial institutions. This chapter also established that there has been increased and renewed interest in corporate governance regulations and practices of companies to enhance their risk management practices. It then summarised the national and international risk governance protocols, which focus on enhancing the risk governance practices of the banking sector. Similarly, it also explained the risk governance weaknesses entrenched in the Nepalese banking industry, despite regulations being issued by the Rastra Bank. This chapter identified the theoretical lens to be used in this project to understand the risk governance practices of Nepalese commercial banks. Similarly, this chapter indicated the framework for which risk management–related corporate governance mechanism would be investigated for exploring the risk governance of Nepalese commercial banks. The following chapter discusses the research design applied to this project to address the research questions outlined in Chapter 1.

CHAPTER 3 RESEARCH DESIGN

3.1 Introduction

This chapter explains the rationales behind each aspect of the research design employed in this project to address the research questions formulated in Chapter 1. Specifically, Section 3.2 explains the methodology and research design applied to this project. Section 3.3 provides justifications for using the sampling methods and outlines the sample size. Section 3.4 justifies the data and data collection methods employed in this project. Section 3.5 explains the various data analysis tools used. Finally, Section 3.6 contains the conclusion of Chapter 3.

3.2 Methodology and Research Design

The selection of a research approach is dependent on various factors, such as the research questions and significant contributions that scholars aim to make in their field of study (Bluhm et al. 2011; Zikmund et al. 2013). The following section justifies the methodology used, and the research design applied for this study.

3.2.1 Methodology

As explained in Section 1.5 of Chapter 1, this project aims to gain in-depth knowledge about the risk governance practices of Nepalese banks with the adaptation of Basel's Principles. In other words, the study aims to describe and explore why and how Nepal's banking regulator is adopting and adapting the international best practices for risk governance. This argument follows from the focus and context of the study, which primarily concerns the commercial banks operating in Nepal. Yin (cited in Lee 1999) claims that a case study research design is appropriate when the research aims to examine why and how contemporary organisation phenomena occur in natural settings. Following the above arguments and research questions developed for this project, this project is a case study of the risk governance of the Nepalese banking industry, and of the commercial banks in particular. Similarly, the case study design allows exploring the research field in more detail (Lee 1999; Thomas 2013) because the case study allows the researcher to focus on one or a relatively small set of cases (Lee 1999;

Maxwell 2013; Thomas 2013). Thus, these arguments justify that, to achieve the project's objective, the case study method is the most suitable to apply.

3.2.2 Research Design

The research questions introduced in Chapter 1 suggest that a qualitative methodology is the most appropriate research design to apply for this project. Governance scholars have recommended the use of a qualitative research design to explore corporate governance phenomena. For instance, a qualitative research study can be an important methodology to explore corporate governance phenomena, particularly within the national context (McNulty, Zattoni, & Douglas 2013). McNulty, Zattoni and Douglas (2013) argue that using rigorous qualitative methods in the exploration of governance phenomena can help governance scholars to consider a country's specific legal and cultural foundations, which affect the governance issues of a particular nation. Thus, a qualitative research design can facilitate a richer and more profound understanding and knowledge of governance phenomena, which can contribute to build and improve more effective governance mechanisms (McNulty, Zattoni & Douglas 2013). Similarly, the qualitative research design allows the governance scholar a basis to rethink and challenge how governance actors function in reality (McNulty, Zattoni & Douglas 2013; Zattoni, Douglas & Judge 2013). Yasin, Muhamad and Sulaiman (2014) view that rigorous and relevant qualitative research methods allow scholars to gather in-depth information in the field of corporate governance. Qualitative research is suitable to gain a better understanding of corporate governance phenomena (McNulty, Zattoni & Douglas 2013; Zattoni, Douglas & Judge 2013).

Maxwell (cited in Maxwell 2013) claims that qualitative research design allows for an understanding of how events, processes, actions and meanings are shaped by the unique contexts in which these events and actions occur. Qualitative research also allows for comprehending how participants understand the events and actions that are taking place in a particular situation (Maxwell 2013). It allows for recognising how participants' understanding of these events and process can influence their behaviours (Maxwell 2013). Based on the project's research aims, research questions, research gap and the above arguments of McNulty, Zattoni and Douglas (2013); Zattoni, Douglas and Judge (2013); and Yasin, Muhamad and Sulaiman (2014), it follows that a qualitative research design is the best to employ for this project. Hence, the qualitative methodology is applied in this study.

3.3 Sample of the Project

Nepalese commercial banks have different ownership structures. Based on their ownership pattern, the banks of Nepal are categorised into different groups. For example, in Nepal, commercial banks are categorised broadly into public and private banks, based on the banks' ownership and control (Bank Supervision Department 2019). The privately-owned commercial banks in Nepal can be further grouped into fully-owned domestic banks and banks with foreign joint investments, known as foreign joint-venture banks (Bank Supervision Department 2019).

Table 3-1: Classification and Total Number of Commercial Banks Based on Ownership Structure as at Mid-July 2018

Classification and Total Number of Commercial Banks Based on Ownership Structure as at Mid-July 2018		
Public Banks	**Private Banks**	
	With Full Local Ownership	*With Foreign Ownership*
3	20	5
Total Commercial Banks	**28**	

Source: Bank Supervision Department (2019)

As shown in Table 3-1, above, 28 commercial banks were operating in Nepal as at mid-July 2018 (Bank Supervision Department 2019). As mentioned in Chapter 1, a full list of Nepalese commercial banks is in Appendix 1-3.

Initially, this project aimed to include and select at least one bank from each category represented in Table 3-1, to represent all categories of banks in the project's sample. However, due to data limitations, the project could not include banks with all ownership structures as initially proposed. These data limitations related to the full set of data available from commercial banks' annual reports, as well as the cost and time involved in translating the annual reports from Nepali into English. For instance, all banks from the public bank category were excluded from the study because the complete data set from these three banks were not available on their websites. Similarly, the majority of commercial banks with full local

ownership did not make their full set of data available in the English language. Therefore, these banks were also not considered for the sample of the project.

Given these limitations, the project used two primary sampling criteria: availability of a full set of primary data, and availability of annual reports in the English language. Thus, to analyse the risk governance practice of banks among Nepalese commercial banks, this project used the convenience sampling method (Savin-Baden & Major 2013). The sample for this project consists of four banks operating in Nepal: two banks with full local ownership, and two banks with foreign ownership. Precisely, this project selected Citizens Bank International Limited (CTZN) and Sunrise Bank Limited (SRBL), representing banks with full local ownership; and SCB and EBL, representing banks with foreign ownership.

3.4 Data and Data Collection

As mentioned in Chapter 1: Introduction, this project aims to gain an in-depth understanding of the risk governance practices of commercial banks regarding the Basel Principles. Therefore, this project focuses on the implementation of the Basel Accords by the Rastra Bank and Nepalese commercial banks. It follows from this objective that this project can collect data from public documents. Savin-Baden and Major (2013) claim that researchers can retrieve information and data from public documents to understand the research context. Stake (1995) also views public documents as appropriate when researchers cannot observe and record research activities directly. Thus, public textual documents were used to collect the data for this project. A crucial question to address, however, was where and how to locate the official public documents that could serve as primary data for the study.

The research objective and research questions formulated in Chapter 1 indicate that this project requires three sets of primary data. First, the Basel Accords documents, which provide the frameworks on the risk governance mechanism for banks. Second, the Rastra Bank's documents, which mandate commercial banks in implementing risk governance mechanisms through various laws and regulations. The Rastra Bank documents are indispensable because these documents provide the benchmark against the Basel Accords and the commercial banks' practice. The third set of data for this project is the annual reports of commercial banks, which can confirm whether or not banks have been implementing those regulatory requirements.

An annual report is one type of public textual document, which contains and communicates a corporation's mission, activities, performance and strategic plans. A company's annual report

is also generally easily accessible to the public. Lajili and Zéghal (2005) state that banks' annual reports contain both qualitative and quantitative risk information about the corporation. Nahar, Azim and Jubb (2016) also confirm that the annual reports of firms contain strong risk information. The qualitative researchers in the field of corporate governance have used archival data from annual reports as the primary data source in their studies. For example, Bluhm et al. (2011) states that archival data was the second-most commonplace method used in qualitative research. The findings of McNulty, Zattoni and Douglas (2013) also supported the claim made by Bluhm et al. (2011).

Some of the studies that used annual reports to assess the risk governance practices are detailed as follows. To assess the risk governance practices of 20 large commercial and universal banks from Europe and North America, Mongiardino and Plath (2010) obtained data from 2007 and 2008 from annual reports and proxy reports. Aebi, Sabato and Schmid (2012) had hand-collected risk governance variables from banks' annual reports through their websites. Likewise, to examine the extent of risk disclosure by 30 banks in Bangladesh, Ittner and Keusch (2016) hand-collected data from the annual reports of banks, which they obtained from multiple sources. Nahar, Azim and Jubb (2016) also hand-collected the primary data from banks' annual reports over six years to examine the changes in the risk disclosure practices of banks in Bangladesh. Therefore, using archival data, such as a company's annual report, is a popular qualitative method in research on corporate governance.

The study period of this project covered the three fiscal years from 2015/2016 to 2017/2018. The main reason for commencing the data set from FY 2015/2016 is that the Basel Committee announced significant changes in international standards for risk governance mechanisms and risk disclosures in July 2015. McNulty, Zattoni and Douglas (2013) claim that governance problems and practices evolve, reflecting patterns in legislation, culture and implicit norms regarding relationships among stakeholders. Therefore, this justifies that commencing the data collection from FY 2015/2016 would be the most suitable date to explore how regulators are trying to cope with the governance problems and practices that are evolving over time. The purpose of ending the data set at FY 2017/2018 is because the annual reports of commercial banks for FY 2018/2019 are generally published at the end of 2019. The annual report publication time for a particular FY usually starts at the end of the upcoming year because the official FY of Nepal starts at mid-July. Thus, the data set from FY 2015/2016 to FY 2017/2018 tends to reflect the recent situation of risk governance practices in the Nepalese banking sector.

This data set aims to reveal how Nepalese banking has implemented the evolving international standards.

3.5 Data Analysis

As restated in Section 3.3, above, this project aims to gain an in-depth understanding of the risk governance practices of commercial banks regarding the adoption of the Basel Principles. This project, therefore, analysed the data and findings in two steps. In the first stage of analysis, the project explored why and how the Rastra Bank has been implementing the Basel Standards for risk governance used by the Nepalese banking sector. This project also investigated which of the risk governance standards, concerning the board and senior management's risk oversight function, have been adopted by the Rastra Bank for the Nepalese banking industry. In the second stage, data from the sample banks' annual reports were examined against the NRB requirements, to investigate whether the commercial banks are fully complying with or diverging from those requirements. Figure 3-1 below explains the data analysis process adopted in this project.

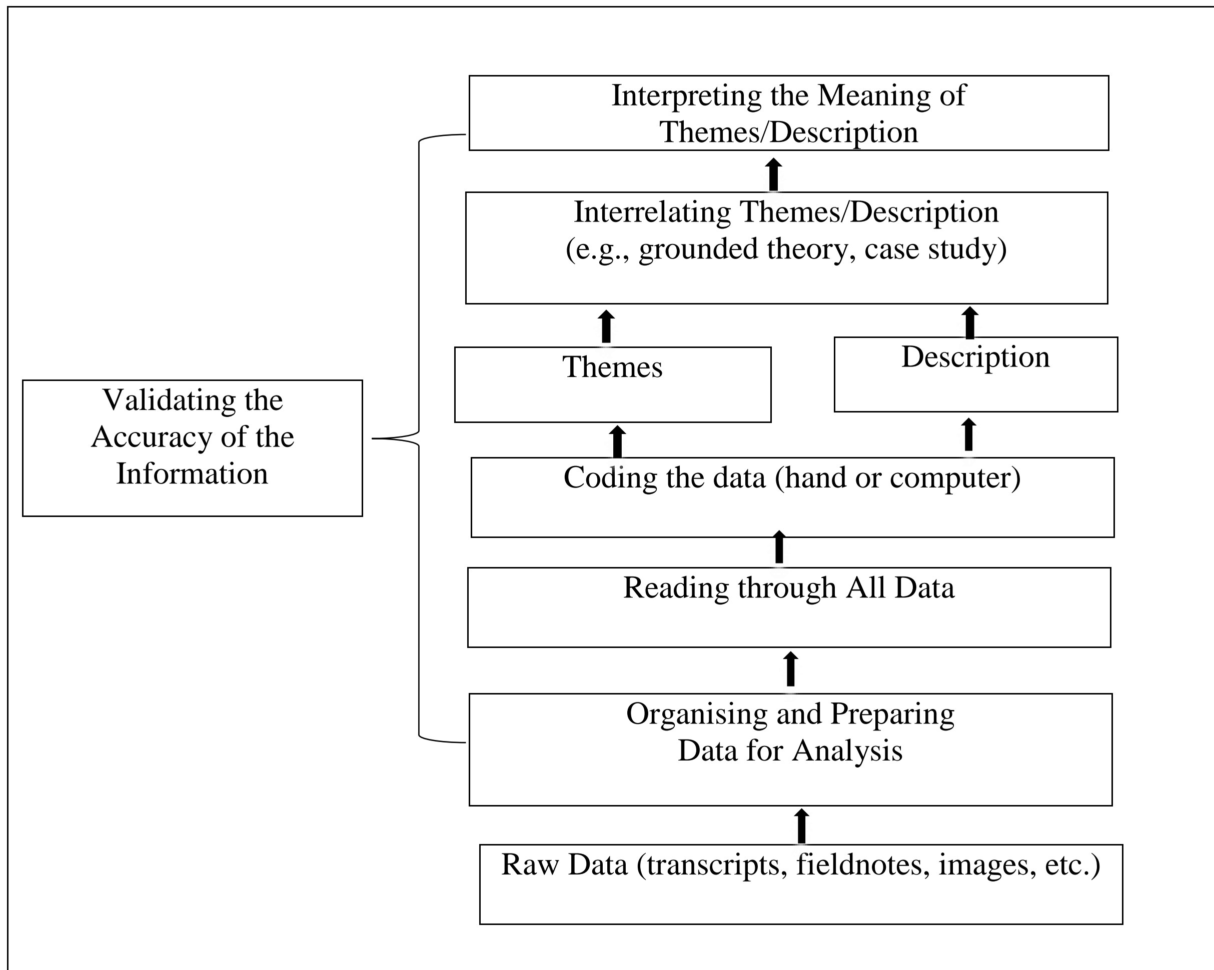

Figure 3-1: Six-step data analysis process

Source: Creswell (2014, p. 197)

3.5.1 First Step of Analysis

Based on the project's aim and research questions, this project has primarily used the NRB's requirements and the Basel Committee's recommendations for understanding the risk governance practices of Nepalese commercial banks. It also used the past literature of risk governance for understanding what mechanisms constitute risk governance in banking. Initially, during the first stage of analysis, the use of disclosure analysis was crucial for this project. Disclosure analysis allows the researcher to thoroughly read the documents to understand the context as well as to identify themes within the data for further analysis (Savin-Baden & Major 2013). Therefore, to understand and identify the Basel Committee's recommendation and the NRB's requirements on risk governance, this project applied disclosure analysis. Savin-Baden and Major (2013) view that disclosure analysis is beneficial

in identifying, categorising and interpreting different themes. Further, identifying the themes helps to narrow down the focus while searching for information (Creswell 2014). The process of identifying themes was helpful to capture the content of the data, which then became essential building blocks for the analysis (Thomas 2013). These themes, falling under headings and sub-headings, will be discussed in Chapter 4.

Within the context of this project, using disclosure analysis was helpful to recognise that the risk oversight function was a crucial element in risk governance. Applying disclosure analysis methods was also advantageous to recognise the scope of the risk oversight function in the banking industry. For example, applying disclosure analysis in this project was useful in categorising the themes broadly into two: first, the risk oversight function at board level, and second, the risk oversight function at senior management level. Thus, given the advantages and suitability of disclosure analysis, this method was deployed in the first stage of data analysis.

In conjunction with disclosure analysis, the project also used the constant comparative method in the first stage of analysis. Because the project seeks to understand which risk governance mechanisms the Rastra Bank implemented in commercial banks, using the constant comparison method was deemed necessary for this project. Thomas (2013) claims that constant comparison allows the researcher to revisit the primary data as frequently as needed to compare, capture, describe and summarise the critical content and facets. Creswell (2014) agrees that the constant comparison method permits the researcher to segment and label data into different categories. Using the constant comparative method in this project was effective to find the similarities and differences in the risk governance mechanisms, as per the Basel recommendation and NRB requirements. Appendix 3-1 outlines the themes: risk governance at the board level and risk governance at the senior management level. In the first stage of analysis, the project focused on identifying whether or not banks were required to have the board and senior managers involved in the banks' risk oversight function. For example, the project investigated whether or not banks are required to establish a separate board-level risk committee for managing risk. The project then investigated the mandates delegated to each risk committee, such as composition, reporting line, independence of the board-level committee, and major responsibilities.

Conversely, for investigating the risk governance at senior management level, this project examined whether or not banks are mandated to establish an independent risk management unit. Similarly, the project examined if banks were obliged to appoint a CRO. In the case of the senior management risk oversight role, this project compared and contrasted the mandates

of risk management departments, as per both the Basel recommendations and NRB requirements. These mandates are listed in Appendix 3-1 under the sub-heading ‘Risk governance at senior management level’. In short, Appendix 3-1 helps to find out how similar or different the NRB’s requirements are with those of the Basel recommendations. The data relating the NRB’s requirements and the Basel Committee’s recommendations were inputted and sorted into a Microsoft Excel sheet. Further, comparing and contrasting the identified themes against the Basel recommendations were helpful to interpret whether the Nepalese banking regulator was following or diverging with the Basel’s guidelines of corporate governance.

3.5.2 Second Step of Analysis

In the second stage, this project investigated whether or not the sample commercial banks are complying with the mandates given by the Rastra Bank. The project used disclosure analysis, content analysis and constant comparative method to investigate the banks’ risk governance compliance with the regulatory requirements. The second step of analysis used disclosure analysis to capture data on different themes. Appendix 3-2 shows themes on the governance variables that are used in the project to examine whether or not the sample banks are confirming the mandates of risk governance mechanisms.

The disclosure analysis in this stage allows for an understanding of whether or not the risk governance information, as listed in Appendix 3-2, was disclosed in the annual reports of the sample banks. The disclosure analysis method is also essential in the second step analysis to identify the section of the annual reports in which the risk governance information was disclosed. For this project, the primary data related to the risk governance features were hand-collected from different sections and sub-sections of sample commercial banks’ annual reports, such as ‘our approach to corporate governance’, ‘corporate governance’, ‘risk governance’, ‘risk review’, ‘board-level committee’, ‘risk management committees’, ‘organisational structure’, ‘a report in the activities of audit committee’, and ‘a report on the activities of risk management committee’. Because the risk governance information required for this project is qualitative, applying a content analysis was deemed necessary for this project. Lajili and Zéghal (2005) view that content analysis helps in capturing the extent and volume of qualitative risk information practices when companies primarily disclosed this risk information qualitatively. Therefore, this project used the content analysis method to capture data on different themes, as demonstrated in Appendix 3-2. This project searched for keywords such as ‘audit committee’,

‘risk management committee’, and ‘the CRO’ from the banks’ annual reports to capture data on different themes.

Just like in the first stage of analysis, the primary data were systematically inputted and sorted into the Microsoft Excel sheet, year by year, for the study period of this project. Systematically inputting and sorting the primary data in this way helped to organise and prepare the data for analysis. Using the Microsoft Excel sheet was helpful in continually comparing the sample banks’ risk governance practices with regulatory requirements, which further assisted in examining whether the commercial banks are conforming with or diverging from the regulatory requirements. For instance, for each board-level committee, the themes focused on finding whether or not banks have established a separate board-level risk committee for managing risk. If yes, then the project investigated compliance with the regulatory mandates. The mandates are related to the composition, reporting line, independence of the committee, number of meetings conducted by the committee, time interval between each meeting, and major responsibilities delegated to each risk committee. This project also attempted to identify whether the banks have similar risk governance practices at the board level.

Conversely, for investigating risk governance at senior management level, the themes that this project generated were investigating whether or not the banks in Nepal had established an independent risk management unit, and whether the banks had appointed a CRO in their organisation. The project investigated mandates and major responsibilities assigned to the risk management department to investigate if banks are complying with regulatory requirements. In addition, in the second step analysis, this project examined if the banks in Nepal have similar or different practices, in terms of who is heading the risk management department, whether the risk management department is independent, the functional title of the head of the risk management function, the reporting lines of the head of the risk management unit, and any dual responsibilities of the head of the risk management department. If the head of risk management had a dual functional role, then the project investigated whether this dual hatting was interrelated or not with the business or operation. All of these themes were analysed using tables wherever appropriate.

The two-step analysis explained above illustrates how this project combined three methods: content analysis, disclosure analysis and constant comparative methods for analysing the data. Zikmund et al. (2013) agree that qualitative researchers conduct research studies in many ways through different techniques, which might also include a combination of two or more approaches. Similarly, Savin-Baden and Major (2013) view that, in a case study research

design, data can be analysed using various techniques. In the case study research design, data can be analysed using various techniques (Savin-Baden & Major 2013). Studies can discuss themes found under headings and sub-headings (Creswell 2014). In this project, themes are dicussed under different headings and sub-headings the Chapter 4. Studies can use different methods for coding data. To illustrate, Creswell (2014) claims that scholars could code all the data either by hand or using computer software. The hand-coding process allows the researcher to concentrate on specific data, which was later used in both comprehending the data and developing a small number of themes for analysis (Creswell 2014; Thomas 2013). Therefore, hand-coding was appropriate for this project. Likewise, in a qualitative research study, the researcher can also generate codes in various ways. For instance, scholars can either use predetermined codes or develop codes based on the prior literature or emerging information collected from the primary data, or in any combination of these (Creswell 2014). This project did not use any of the predetermined codes.

3.6 Conclusion

This chapter has explained the methodology employed to answer the research questions of this project. Within this context, the project has applied an explanatory case study research design. This project used the documentary review approach and applied the convenience sampling method to collect the data. The combination of content analysis, disclosure analysis and constant comparative methods were employed to analyse and interpret the data. The following chapter discusses the results of the investigation.

CHAPTER 4 FINDINGS AND ANALYSIS

4.1 Introduction

This chapter covers the findings and analysis of this thesis. As mentioned in Chapter 1 and explained in Chapter 3, this study's results are analysed in two stages. Section 4.2 covers the Stage 1 analysis, where *public interest* and *agency* theories are applied to explore how and why the Nepal Rastra Bank has adopted the Basel Accords to use in Nepalese banking. Section 4.3 includes the Stage 2 analysis, where the project investigates the sample banks' risk governance mechanisms compliance. Section 4.4 summarises the project's overall observations in implementing the Basel Norms in the Nepalese banking industry. A summary of the Nepal Rastra Bank's challenges in implementing the international best practices is in Section 4.5. Finally, Section 4.6 provides this chapter's conclusion.

4.2 Stage 1 Analysis: The Nepal Rastra Bank's Adaptation of the Basel Accords

It was noted in Chapters 1 and 2 that each country adopts the Basel Accords according to its national law, interpretation, and requirements. This section discusses why it was essential for the NRB to adopt the Basel Accords in Nepal. It also discusses how the NRB adapted the Basel Principles for use in Nepal, and which standards the NRB adopted from the Basel Accords for their risk governance mechanism.

4.2.1 Why Did Nepal and the Rastra Bank Start Adopting the Basel Principles?

Within the context of Nepal, there are two main reasons why Nepal and the NRB had to adopt international best practices in the banking sector. The first reason is the liberalisation policy adopted by the government of Nepal during the 1980s (Nepal Rastra Bank 2005). Khatiwada (2005) claims that there were no significant changes in the Nepalese economy structure until the 1980s. In early the 1950s, for instance, the Nepalese economy depended almost exclusively on subsistence agriculture (Shah 1981), and agriculture contributed more than 90% of GDP in the 1960s (Khatiwada 2005). Similarly, there was almost no industry until the 1970s, because other economic activities were contributing no more than 10%–15% to the country's total

employment and income (Shah 1981). Until early 1951, Nepal's economy was virtually isolated from global economies, except for India (Shah 1981). Nepal's trade–GDP ratio remained less than 15% until the 1970s (Khatiwada 2005), despite Nepal's initiation of building economic relations with other countries since the 1950s (Khatiwada 2005). Further, while Nepal began to evolve its external trade and foreign exchange regimes in the 1960s (Khatiwada 2005), Nepal's consumption expenditure on domestic goods and services still accounted for 84% in 1984/1985 (Khatiwada 2005).

In recent decades, however, the Nepalese economy has made noteworthy structural shifts in term of compositional changes in the country's GDP (Khatiwada 2005). As shown in Chapter 1, with the adaptation of the liberalisation policy, Nepal made significant changes in socio-economic conditions. The services sector, for example, has been emerging as the largest sector in terms of GDP composition. Section 1.3.1 of Chapter 1 also provided evidence on these changes in the Nepalese economy structure.

The above discussion on the structural shift in the Nepalese GDP composition has illustrated that adopting the policy of liberalisation helped Nepal to open its economy and facilitate trade and industries among countries. The development of economic sectors other than agriculture and the increase in the trade–GDP ratio implies that Nepal needs to have a safe and efficient payment system. In recent years, however, many financial markets have made it a virtual necessity for countries to comply with the Basel Accord to access their market (Scott & Gelpern 2016). To illustrate, for accessing its market, the USA requires countries to be representative members in the Basel Committee or to comply with the Basel Standards (Scott & Gelpern 2016). Boora and Kavita (2018) state that banks must comply with Basel Norms. Based on the arguments of Scott and Gelpern (2016), and Boora and Kavita (2018), therefore, it holds that both a country and its banks need to be Basel-compliant. In short, the economic liberalisation policy adopted by Nepal implied that to facilitate its trades and payment, it needed to adopt the Basel Principles to have a safe and efficient payment system.

The second reason is Nepal's increasing membership to international organisations (Nepal Rastra Bank 2005). Along with its initiation to economic openness, Nepal has started to build up its bilateral and multilateral relations with many global organisations. Nepal obtained international membership to the International Monetary Fund (IMF) and The World Bank in 1961. Nepal has also been a prime member of the Asian Development Bank since 1968. Nepal joined with the Asian Clearing Union as a principal partner in 1974. Similarly, Nepal became a member of the World Trade Organization (WTO) in 2004. Memberships to these

international organisations also mean that Nepal has to comply with the specific standards of these organisations to maintain affiliation with them. For instance, the IMF has urged countries to embrace the Basel Standards as a condition for its financial support and conducts periodic surveillance of member countries (Scott & Gelpern 2016).

Because Nepal is a WTO member, it likewise has to comply with the General Agreement on Trade in Services (Nepal Rastra Bank 2010). As per the General Agreement on Trade in Services of the WTO, effective from 1 January 2010, Nepal has to allow foreign BFIs to establish their branches and conduct wholesale banking transactions (Nepal Rastra Bank 2010). The entrance of foreign banks into the Nepalese financial system implies that Nepalese banks have to be competitive. Nepal's affiliation with international organisations thus encouraged Nepal to open their financial market for foreign players; at the same time, it had to embrace the Basel Accords. From these arguments, it follows that the Nepalese banking system needed to adopt the Basel Standards in because of various factors, such as the government's introduction of domestic's policies, shifts in the country's structural economic sectors, and prerequisites to maintain its affiliation with international bodies.

4.2.2 How Did the Nepal Rastra Bank Start Adopting the Basel Standards?

As discussed earlier, Nepalese economic sectors, including the banking sector, started to make significant changes after the country adopted the liberalisation policy. As the Nepalese economy started to make structural shifts in economic activities, the Nepal Rastra Bank Act 1955 became inconsistent (World Bank 2002). With financial liberalisation, for example, there was an increase in the number of banks operating in the country (Bank Supervision Department 2002). These joint-venture banks came with new technologies and management knowledge (Bank Supervision Department 2002). The establishment of private banks brought changes in the business model of the Nepalese banking sector, particularly with the use of modern ICT in banking. The NRB Act 1955 was designed, however, for supervising and regulating state-owned banks (World Bank 2002). Considering these structural changes in the banking sector, the legal framework governing the banking system, the NRB Act 1955, became obsolete (World Bank 2002).

In June 1955, an assessment of Nepal's compliance with the *Basel Core Principles for Effective Banking Supervision* (BCPs) was conducted (World Bank 2002). The findings of this assessment concluded that the Rastra Bank had failed to comply fully with two-thirds of the BCPs (World Bank 2002). The results established that Nepal Rastra Bank was experiencing

difficulties in fulfilling its supervisory mandates (World Bank 2002). The findings also revealed that almost none of the preconditions required by the Basel Committee existed in Nepal (World Bank 2002). Some of these preconditions were inadequate legal frameworks, the nonexistence of the NRB's operational independence, absence of a market-based banking business system, and inadequately strong internal structure (World Bank 2002). The findings from the World Bank (2002) implied that the NRB Act 1955 was inadequate for the NRB to execute its supervisory and regulatory functions. The authority granted to the NRB did not sufficiently permit it to supervise the financial sector adequately, and to facilitate the growth and improvement of the country's financial infrastructure and market (World Bank 2002). The results of this assessment implied that the NRB Act 1955 had granted too little power to the Central Bank of Nepal. The 1955 assessment also revealed that the NRB Act 1955 was not suitable for a modern banking system (World Bank 2002).

To address the weaknesses and inadequacies identified in the NRB Act 1955, the NRB issued seven new banking regulations in 2001 (World Bank 2002). According to the Bank Supervision Department (2002), this new set of regulations, NRB Regulations 2001, were based on the *Core Principles of Bank Supervision* of the 1988 Basel Accords published by BIS. The regulations were drafted and published with the consultative assistance of the World Bank, which consisted of Directives under seven headings (Bank Supervision Department 2002). These regulations covered capital adequacy, loan classification and provisioning, single obligor limit, accounting policies and financial statement, and corporate governance (Bank Supervision Department 2002). The Directives issued on corporate governance in mid-July 2001 prohibit banks from granting loans and advances to the bank's promoters and directors (Bank Supervision Department 2002). One of the provisions in the Corporate Governance Directives was for banks to establish an internal audit committee under the chairpersonship of a non-executive board member (Bank Supervision Department 2002). Thus, Nepal began to adopt the Basel Accord formally from 2001 to enhance business practices and address the risks of the banking business.

While the revised regulations of 2001 sought to provide higher regulatory power to the Rastra Bank, by early 2002, the Rastra Bank was already encountering resistance to their implementation (World Bank 2002). Meaningful implementations of this revised regulation were thus a challenge for the Rastra Bank (World Bank 2002). Despite resistances and challenges, however, the new NRB Act 2002 was enacted in 2002, replacing the NRB Act 1955 and Currency Act 1983 (Nepal Rastra Bank 2018). The NRB Act 2002 refined the role of the

Central Bank in the economy (Nepal Rastra Bank 2018) and made the Rastra Bank more autonomous (Nepal Rastra Bank 2018). The NRB Act 2002, for instance, gives full legal power and authority to the Rastra Bank to regulate the functions and activities of BFIs under the jurisdictions of NRB. To regulate the functions and activities of BFIs, the Rastra Bank can frame rules and Bylaws and can issue necessary orders, Directives and circulars to commercial banks and other financial institutions to make BFIs abide by these rules, Bylaws, Directives and circulars. As per the NRB Act 2002, the Rastra Bank can also seek to obtain detailed particulars, information, data, records and documents from BFIs for inspection and supervision. The NRB Act 2002 has entrusted the NRB with the legal power to conduct investigations or inspections of the books and accounts, documents or records of BFIs to determine whether or not BFIs are conducting their business under the NRB Act 2002, rules, Bylaws, Acts, Directives, circulars and orders.

Later, on 14 November 2016, the NRB Act 2002 was further amended. The objective of this the 2016 NRB Act amendment was to make the NRB more efficient and effective within a changing context, with the focus being given to financial consolidation rather than financial expansion, and with priority accorded to financial access. According to Section 4 of the NRB Act 2002, second amendment 2016, the Central Bank's objectives have also been revised. According to this revision of the NRB Act 2002, the NRB has three key objectives. The first objective is to formulate necessary monetary and foreign exchange policies to maintain stability in the price and balance of payment for economic stability and sustainable economic development. The second objective is to increase access to financial services and public confidence in the banking and financial system. The third objective is to develop a secure, healthy and efficient payment system.

According to Nepal Rastra Bank (2018), separate Acts were governing separate institutions even until 2004. The Nepal Bank Limited and Rastriya Banjiya Bank Limited (RBB), for instance, had separate Acts for their institutions (Nepal Rastra Bank 2018). The Banking and Financial Institution Ordinance 2004, however, became the first umbrella legislation to regulate and supervise all BFIs under single legislation (Nepal Rastra Bank 2018). This ordinance unified the scattered legislations to harmonise banking practices (Nepal Rastra Bank 2018). Later, this ordinance became the Bank and Financial Institution Act (BAFIA) 2006. The BAFIA 2006 is based on international banking norms and standards (Acharya 2018). The BAFIA not only entrusted the NRB with more supervisory and enforcement power (Nepal Rastra Bank 2018) but also provided the NRB with legal authority to discipline BFIs by

enhancing corporate governance in the BFIs (Nepal Rastra Bank 2018). The BAFIA 2017 has since provided the authority to impose a complete or partial ban on banking and financial transactions, suspension of boards of directors, and takeover by Central Bank for problematic commercial banks and financial institutions, as well as the cancellation of operating licences. For instance, BAFIA has given the NRB legal rights to suspend or revoke the banking licences of BFIs, if BFIs operate against the interests of depositors or violate the NRB Act, BAFIA, Bylaws or Directives.

Nepal Rastra Bank (2018) states that the NRB issues prudential guidelines in the form of Directives to regulate activities that help to make the financial system sound, safe and stable. These Directives play a crucial role in maintaining the economy's financial stability and helps to enhance public confidence in the financial system (Nepal Rastra Bank 2018). Within the context of the financial sector reform process and rapidly changing financial conditions, the Rastra Bank's objective and role have been changing to incorporate this changing financial landscape and need. The NRB Unified Directives have continued to date by amending and updating them with changing circumstances (Nepal Rastra Bank 2018). For example, the NRB Directives were extended from seven headings in 2001 to 16 in 2006 (Nepal Rastra Bank 2018). Likewise, in 2007, the NRB added Know Your Customer (KYC) and Credit Policy to the Unified Directives (Nepal Rastra Bank 2018). Currently, there are 23 headings under the Unified Directives (Nepal Rastra Bank 2018). These revisions and amendments to the regulations indicate that the NRB has been revising its Acts and Directives to fit the features and needs of the Nepalese domestic market.

4.2.3 What Standards for Risk Governance Are Adopted from the Basel Norms by the Nepal Rastra Bank and Used by the Nepalese Banking Sector

As mentioned earlier, under the NRB Act 2002 and BAFIA 2017, the NRB has been regulating and supervising BFIs in Nepal through various Directives and regulations. The structure for the risk governance mechanism of the banks is covered in Sections 60 and 61 under BAFIA 2017 and the Terms of Reference (ToR) in Unified Directives 2075 under the Nepal Rastra Bank Act 2002. Similarly, the Basel Principles, such as Principles 3 and 6 of *Corporate Governance Principles for Banks*, contain guidelines for the risk governance structure of an internationally active bank (Basel Committee on Banking Supervision 2015). These aforementioned Basel Principles, Acts and Directives have therefore been used to analyse the risk governance of the Nepalese banking industry.

"*Principle 3*" outlines the guiding principles for the Board's structure and practices for an appropriate risk governance mechanism (Basel Committee on Banking Supervision 2015). This principle states that, depending on several factors such as a bank's size, Board's size, business nature and risk profile, the board can mandate to establish specialised board sub-committees (Basel Committee on Banking Supervision 2015). Such board sub-committees can assist the board to have an in-depth and greater focus on particular areas wherever necessary (Basel Committee on Banking Supervision 2015). As per the Basel Committee on Banking Supervision (2015), board sub-committees can help to increase the board's efficiency and functioning. Some of the board-level committees mentioned by the Basel Committee on Banking Supervision (2015), which look after risk management issues, are audit and risk management committees. Each committee should have a charter or other instrument that sets out its mandate, scope and working procedures (Bank for International Settlements 2015, p. 16).

Conversely, as per Section 60 of BAFIA 2017, the Nepal Rastra Bank mandates that commercial banks should establish a board-level audit committee to look after risk management. Similarly, Section 61 of BAFIA 2017 specifies the functions, duties and power of a bank's audit committee. As per the ToR in the Unified Directives 2075 under the Nepal Rastra Bank Act 2002, the commercial banks should establish a board-level risk management committee (Bank and Financial Institutions Regulation Department 2018).

4.2.3.1 Risk Governance at Board Level

From the above section, it is clear that both the Basel Committee and Rastra Bank have required banks to establish audit and risk management committees in their banks. The following section explains the major differences and similarities of each of these board sub-committees as per the Basel and NRB.

4.2.3.1.1 Audit Committee

Appendix 4-1 summarises the audit committee's mandate as per the Basel and NRB. It provides a snapshot of how a banking audit committee should be structured and functioned as per Basel recommendations and NRB requirements. Appendix 4-1 shows that, while the NRB's regulatory requirements are similar to the Basel recommendations, there is a significant difference in the mandates provided to the audit committee. While both the Basel and NRB, for example, have mandated banks to establish an audit committee, in the case of the audit

committee's chairperson, the Basel Committee has specified that non-executive Director should chair this committee. The Basel Committee specifies that the chairperson of the board or any other board sub-committees should not head the audit committee, while the NRB states that neither a bank's chairperson, chairperson of other board sub-committees, nor CEO of the bank, should chair the audit committee.

Some other notable differences can be observed in the formation of the audit committee. There are also key differences in the audit committee's composition and committee members' experience. For instance, the Basel Committee does not specify the exact number of members who should participate in the audit committee. The Basel Committee also states that members of the audit committee should have experience in audit practices, financial reporting and accounting. Conversely, while the NRB states that the audit committee should comprise of three members, it is silent in terms of the experience of the audit committee's members. Likewise, while the Basel guideline does not specify how often the audit committee should meet, as per the NRB requirements, the audit committee meeting should usually be held once every three months.

In summary, the comparison criteria of the audit committee's mandate relate to its existence, composition and reporting line, and the number of meetings conducted by the audit committee. Analysing the power, functions and duties of the audit committee is equally important to understand the functioning of the audit committee. Therefore, these parameters are compared and analysed in this project. Appendix 4-2 summarises the responsibilities and authorities of the audit committee for both the Basel Committee and Rastra Bank.

Referring to Appendix 4-2, it can be observed that, compared to the Basel Committee's guidelines, the NRB has a narrow focus and scope of the audit committee's duties and functions. According to the Basel Committee, banks are recommended to make their audit committee responsible for overseeing the financial reporting process, as well as for ensuring that senior management is taking necessary corrective actions on a timely basis to address weaknesses, problems and non-compliance with policies, laws and regulations, and other issues identified by auditors and other control functions. The Basel Committee has also recommended that the audit committee should have the authority to approve or recommend the board as to the approval, appointment, remuneration and dismissal of external auditors. Likewise, as per the Basel Committee, the bank's audit committee is responsible for reviewing third-party opinions about the design and effectiveness of the bank's overall risk governance framework

and internal control system. Similarly, as per the Basel Committee, the audit committee is responsible for reviewing and approving the audit scope and frequency.

According to the NRB, however, apart from ensuring that the bank's books of records were prepared according to the prevailing laws, regulations and Directives of the Rastra Bank, the audit committees are also accountable for providing opinions on other areas as required by the board. As per the NRB, the audit committee is responsible for recommending the three names of external auditors. The audit committees of commercial banks in Nepal are also required to monitor and audit the bank's management and operation, then to provide a report to the board on the status of the BFI's performance and compliance to the applicable Acts, Rules, Bylaws, policies and specified Directives. These audit committee functions indicate that the audit committee is responsible for ensuring the accuracy of reports and compliance with applicable Acts, Rules, Bylaws, policies and specified directives of BFIs. In all, comparing the audit committee's functions as per the NRB requirements with the Basel Committee's recommendations shows that the audit committee's scope of operation in the Nepalese banking sector is limited.

4.2.3.1.2 Risk Management Committee

Similar to the audit committee, the recommendations for the risk management committee is discussed in Principle 3 of *Corporate Governance Principles for Banks*. Through "*Principle 3*", the Basel Committee explicitly provides details on how the risk management committee should be chartered, along with its mandate, scope and working procedures. The Nepal Rastra Bank provides guidelines for the Risk Management Committee's functioning through the ToR in the Unified Directives 2075, which was issued under the Nepal Rastra Bank Act 2002. Appendix 4-3 provides a summary on how the risk management committee in BFIs should be established and function as per the Basel Principles and NRB requirements. Like in the previous investigation of the audit committee's mandates, the RMC's mandates have been further investigated as to its existence, composition, reporting line and the number of meetings conducted by the RMC.

Appendix 4-3 shows that, while the RMC's mandates as per the NRB's regulatory requirements are relatively similar to the Basel recommendations, there is a major difference in the mandates provided to this committee. For example, both the Basel and NRB mandate banks to establish an RMC. In terms of the RMC chairperson, however, the Basel Committee specifies that non-executive Director should chair this committee and that the RMC chairperson should not also

be the chairperson of either the board or any other board sub-committees. Conversely, the NRB states that the RMC chairperson should be a non-executive director.

Some of the notable differences observed in the formation of the RMC relate to the number of members in the committee, and their experience. For instance, while the Basel Committee does not specify the exact number of members who should be in the RMC, it states that most RMC members should be independent, who have experience in risk management issues and practices. The NRB specifies that the Head of the Operations Department should be a member of the RMC. Likewise, the Head of the Credit Department or Head of a separate unit looking after risk management, if any, should be its member secretary. While the Basel guideline does not specify how often the RMC should meet, as per the NRB requirements, the RMC meeting should typically be held once every three months.

In summary, the comparison criteria of the RMC's mandates relate to its existence, composition and reporting line, and the number of meetings conducted by the RMC. However, analysing the power, functions and duties of the RMC is also equally important to understand the functioning of the RMC. Therefore, this project has compared and analysed these parameters. The responsibilities and authorities of the risk management committee are outlined in "*Principle 3*" of the Basel Committee's *Corporate Governance Principles for Banks* and the ToR in the Unified Directives 2075 under Nepal Rastra Bank Act 2002. Appendix 4-4 summarises the responsibilities and authorities of the RMC as per both the Basel Committee and Rastra Bank. From Appendix 4-4, it can be observed that similar to the audit committee's functioning, the RMC has a limited scope of operation when the guidelines from the NRB are compared with the Basel Committee recommendations.

4.2.3.2 Risk Governance at Senior Management Level

Chapter 2 illustrated that senior management should be part of the risk governance of banks because the risk management function acts as a second line of defence. Here, the risk governance at the senior management level is analysed against both the Basel and NRB.

4.2.3.2.1 Establishment of an independent risk management function and appointment of Chief Risk Officer

The Basel Accords and NRB have recognised the risk management function as the key component in a bank's second line of defence. Appendix 4-5 summarises the mandates of the

risk management function and CRO. As outlined in Appendix 4-5, both the Basel and NRB require banks to form their risk management function under a CRO. The Basel Committee recommends establishing a risk management function that is independent of other business and operation units. The Basel Committee also specifies that the risk management function should have the authority to oversee the enterprise-wide risk management activities of the bank. As per the Basel Standards, for example, the head of risk management functions should be managed by a senior manager, or equivalent to senior manager, with a functional title such as CRO. Similar to the Basel recommendations, the Rastra Bank requires commercial banks to establish a risk management unit and to appoint a CRO, or equivalent, to act as the head of this unit. The Basel Committee further elaborates the function of the CRO by stating that the appointment, dismissal or any other changes regarding the CRO's position, such as his/her compensation and performance, should be reviewed and approved by the board or board risk committee. The Basel Accords require banks to discuss with their supervisory body the reason for a CRO's dismissal. The Basel guidelines also require banks to disclose the information of such removal publicly. The Basel Committee outlines other aspects of the CRO, such as his/her authority, power and independence.

In the context of the Nepalese banking industry, however, the NRB does not mandate that banks should discuss the dismissal of a CRO with their supervisory body. Likewise, the NRB does not specify any requirement to disclose the information regarding the CRO's removal publicly. The NRB only specifies that the Board, or its RMC, should review the CRO's performance.

Further, the Basel Committee states that a bank's CRO should have the necessary skills and organisational stature and authority to manage the bank's risk activities. To illustrate this point, the CRO should have sufficient independence, access to any required information without any impediment, and a direct line of access or report to the board or board risk committee. The Basel Committee also recommends that this risk management function should be sufficiently distinct from other functional units. The Basel Principles state that, when 'dual hatting' is inevitable, in such case, the CROs' independent functioning should be ensured. For example, the CRO should not be involved in revenue generation, hold line responsibility or participate in business decision-making or the approval process. The NRB specifies the exact requirements for the independent functioning of the CRO. When comparing other aspects of the Basel and NRB's mandates, however, in terms of risk governance at senior management level, the NRB lacks focus on crucial aspects regarding the CRO's compensation and dismissal.

4.3 Stage 2 Analysis: Exploration of Nepalese Commercial Banks' Compliance to Risk Governance Mandates

Section 4.2.3, above, discussed several standards that have been adopted by the Nepal Rastra Bank for the risk governance of the Nepalese banking sector. This section investigates the commercial banks' compliance with national regulatory requirements on risk governance mechanisms, as identified in Section 4.2.3. This analysis will help to investigate if whether the sample banks have similar or distinct mechanisms for the set-up and function of the risk governance mechanism in their respective banks.

4.3.1 Risk Governance at Board Level

This section discusses compliance with the different mandates specified by the Rastra Bank for the functioning of both the audit and risk management committees.

4.3.1.1 Audit Committee

This section investigates the practices of the sample banks, in terms of compliance or non-compliance to the different mandates given to the audit committee's functioning by the Rastra Bank. From Appendix 4-6, it can be concluded that all the banks have conformed with the mandates of the establishing the audit committee in their banks. Appendix 4-6 also shows that, apart from for EBL for FY 2015/2016, and FY 2016/2017, all of the sample banks over the study period complied with the Rastra Bank's other mandates for the RMC's functioning.

While going through the annual reports of the sample banks, some data discrepancies were detected. In their annual reports, SRBL and CTZN have some data inaccuracies in their reporting of the statistics for the number of audit meetings conducted. To illustrate this point, in the Citizen International Bank Limited's annual report of FY 2015/2016, page 44 mentions there being 15 audit committee meetings. In contrast, on page 98 for the same fiscal year, the audit committee meeting is stated as being held 16 times.

Similarly, there is inconsistent information in SRBL's annual reports of FY 2015/2016 and FY 2016/2017, regarding the number of times the audit meeting was conducted. Pages 37 and 69 of SRBL's annual report of FY 2015/2016 mentions that five audit committee meetings were held in that year. Page 68, however, mentions that the audit committee meeting was held nine times during the review period. In SRBL's annual report FY 2016/2017, rather than the

exact number of meetings held, it states that the audit committee met the regulatory requirement. All this information reveals that there is not the only variation in how many times the sample banks conducted their audit meetings, but also there are inaccuracies in the information they have furnished.

As per Section 60 subclass (4) of BAFIA 2017, commercial banks are required to conduct their Audit Committee at least once per quarter. Therefore, this project attempted to discover if all sample banks fulfilled this mandate. From the annual reports of the sample banks, it can be observed that only the CTZN furnished the details of each meeting. SRBL and SCB have not provided details regarding the duration of each meeting. With this lack of information, therefore, it cannot be determined if banks were conforming to the Rastra Bank's frequency for the audit committee's meetings. However, CTZN has complied with the regulatory requirement throughout the sample period.

In term of the audit committee's chairperson, this project has found that, in all the sample banks, the coordinator of the audit committee was a non-executive director, except for EBL from FY 2015/2016 to FY 2016/2017. Further, it was noted that the banks' chairperson in the audit committee, as mentioned earlier, was not serving in the same capacity for other committees. The project found that the audit committees' coordinators were also members of the RMC. Therefore, except for EBL from FY 2015/2016 to FY 2016/2017, all other sample banks appeared to be complying with the requirement of the audit committee's chairperson. Regarding the Secretary of the audit committee, it was observed that, among the sample banks, SRBLhad a different practice of appointing the secretary of the audit committee. For example, from FY 2015/2016 to FY 2016/2017, it was observed that the bank's Company Secretary was the member secretary of the audit committee. Only in FY 2017/2018 did the CRO serve as the member secretary of the audit committee. For the remaining sample banks, the head of the internal audit department attended the meeting as the member secretary of the audit committee. These practices illustrate that the sample banks varied in terms of who acts as the member secretary of the audit committee.

4.3.1.2 Risk Management Committee

Similar to the investigation of the audit committee in Section 4.3.1.1, above, this section presents the findings on the sample banks' compliance or non-compliance to the Rastra Bank's mandates regarding the functioning of the risk management committee. From Appendix 4-7, it can be concluded that the banks have all conformed with the mandates of establishing an RMC

in their banks. It can also be concluded that, apart from for EBL for FY 2015/2016 and FY 2016/2017, all the sample banks over the study period have complied with the mandates of the Rastra Bank for the RMC's functioning.

Similar to the Audit Committee requirement, commercial banks are required to conduct their RMC meeting at least once per quarter. Therefore, this project attempted to discover if all the sample banks fulfilled this mandate. From the sample banks' annual reports, it can be observed that only CTZN furnished the details of each meeting. SRBL and SCB did not provide details regarding the duration of each meeting. With this lack of information, therefore, it cannot be determined whether those meetings were held at each quarter. However, CTZN complied with the regulatory requirement throughout the sample period.

4.3.2 Risk Governance at Senior Management Level

Section 4.2.3.2, above, discussed various risk governance mandates, which are recommended by the Basel and NRB at senior management level for their risk governance role. The following section investigates the practices of the sample banks in complying with the mandates required by the Rastra Bank at senior management level.

By analysing Appendix 4-8, it can be observed that, except for EBL, the remaining sample banks provided information regarding the existence of both a risk management unit and CRO. The data from CTZN and SRBL reveal that their risk management department was established during the sample period. In the case of SCB, while it did not mention the existence of its risk management unit, it has had a CRO appointed since FY 2015/2016. Thus, SCB has had risk management function in its bank since this time. From Appendix 4-8, it can be seen that the Officiating Head, Head of the risk management department and Chief Risk Management Officer headed the risk management functions.

Regarding the CRO's reporting line, apart from CTZN, none of the other sample banks provided sufficient information. Due to lack of sufficient information available in sample banks' annual reports, it could not also be concluded whether or not the CRO was functioning independently. Throughout the sample period, however, CTZN had an independent CRO. The independency of the CRO at CTZN was illustrated through his/her direct reporting to the Risk Management Committee.

Regarding the practice of the CRO's 'dual hatting' in the sample banks, this dual hatting varied across the study period for the sample banks. For example, in FY 2016/2017, while some banks

mentioned that their CRO had a dual role, others stated that they did not have a CRO with a dual role. The other role assigned to the CRO also varied across the sample banks. For example, the CRO of SCB had the additional responsibilities of being Senior Credit Officer throughout the sample period. Similarly, while CTZN's CRO had no additional role till FY 2016/2017, he/she had been assigned the role of Recovery Officer in FY 2017/2018. Likewise, the CRO of SRBL handled the additional role of Company Secretary in FY 2016/2017.

4.4 Overall Observations on the Governance Mechanisms in the Nepalese Banking Sector

According to the Basel Committee on Banking Supervision (2015), Principles 3 and 6 of *Corporate Governance Principles for Banks* contain guidelines for the risk governance structure of an internationally active bank. Pelzer (2013) views that the Basel Accords outline the regulatory guidelines for banking operation and risk management, particularly for an internationally active bank. However, as discussed earlier, the Basel Norms are considered to be the best international benchmark for banking regulations to build a resilient banking system (Ljubić, Pavlović & Milančić 2015). Becoming Basel-compliant is, however, not an easy task for developing economies (Boora & Kavita 2018). Boora and Kavita (2018) view that many of the protocols recommended in the Basel Norms are not readily fully applicable to developing or less-developed countries. For example, while the Basel Committee has recommended that banks should use an advanced approach for capital fund calculation, as shown in Appendix 4-9, it is not applicable in the Nepalese banking context. Due to various constraints, such as the lack of credit rating practices, the Nepalese banking sector is not in a position to apply this Basel's advanced approaches (Nepal Rastra Bank 2013; Uprety 2013). As such, the Nepal Rastra Bank has prescribed the simplest of the available approaches (Nepal Rastra Bank 2013, 2015a) such as *Simplified Standardized Approach* for credit risk, *Basic Indicator Approach* for operational risk and *Net Open Position Approach* for market risk (Nepal Rastra Bank 2013; Uprety 2013).

Similarly, developing countries also face certain constraints for practising sound corporate governance. One of the constraints that developing economies come across is that they have insufficient institutional memories, experiences and expertise compared to those of advanced economies, which nurture sound corporate governance practices (McGee 2010). From this argument, it follows that, for developing nations such as Nepal, these constraints hinder the practice of robust corporate governance mechanisms. More importantly, the Nepalese banking

sector does not have adequate infrastructure, such as strong information technology, robust MIS and competent human skills (Bank Supervision Department 2018, 2019; Uprety 2013), which are essential for robust risk governance practices. These insufficient infrastructures are challenging for implementing the risk governance mechanism in the Nepalese banking sector.

Likewise, Section 4.3 demonstrates that the Nepalese banking industry is steadily improving its risk governance practices and disclosures on risk governance. There is a lack of adequate information from the banks' annual reports and non-disclosures from the regulator on compliance with risk governance. The information furnished by the Nepal Rastra Bank for its enforcement actions contains only information relating to monetary penalties for breaches of prudential regulatory measures, such as failing to maintain the capital adequacy ratio, cash reserve ratio, statutory liquidity ratio and deprived sector lending. These punitive courses of action from the Rastra Bank show that the Rastra Bank is disciplining poor business practice and pursuing compliance. However, there is no information furnished on the breaches for risk governance mechanism for both the board and senior management levels. For example, there is no information provided regarding whether or not commercial banks are fulfilling the mandates outlined in the above section regarding audit committees, risk management committees or senior management. Furthermore, there is no information disclosed regarding the enforcement action undertaken by the NRB for breaches of regulatory risk governance mechanism.

This non-disclosure illustrates that the Nepal Rastra Bank is practising selective disclosure on enforcement actions for the risk governance mechanism. With this insufficient or lack of the information, it difficult to conclude the sample banks' compliance status to the NRB mandates. This selective non-disclosure on the Rastra Bank's enforcement action for the risk governance mechanism might indicate, however, that the Rastra Bank is pursuing an educative approach towards compliance. The lack of information in compliance enforcement can be justified with the challenges identified by the Rastra Bank in implementing the Basel III. The following section briefly explains the problems identified by the NRB.

4.5 Challenges Identified in the Implementations in Basel III In Nepalese Commercial Banks

Complying with the Basel Norms is not an easy task. The country, banking regulator and the banking institutions of Nepal face several challenges in implementing the Basel Norms. Some of the key challenges identified in implementing the Basel III are discussed below.

4.5.1 Lapses in the Effective Supervisory Practices of the Rastra Bank

As noted earlier, the NRB is responsible for the supervision and regulation of BFIs in Nepal. The NRB has established four different supervision departments, including Bank Supervision, Development Bank Supervision, Finance Company Supervision, and Micro Finance Promotion and Supervision Departments, to supervise each class of BFIs under its jurisdiction (Bank Supervision Department 2018). Arrangements have been made so that each department supervises its respective class of banks to make supervision more effective (Bank Supervision Department 2018). The Bank Supervision Department mainly conducts supervision of the commercial banks of Nepal through onsite inspection and offsite surveillance (Bank Supervision Department 2014, 2017, 2019). The Bank Supervision Department comprises the Onsite Inspection, Enforcement, Offsite, Policy Planning and Analysis, Special Inspection, and Internal Administration units (Bank Supervision Department 2019). Bank supervision aims at examining the risks that commercial banks face and their ability to manage those risks (Bank Supervision Department 2012, 2019). Likewise, during these supervision and inspections, the department reviews for compliance with regulatory requirements such as Acts, rules and regulations, as well as adherence to the banks' own internal policies, procedures, manuals and guidelines (Bank Supervision Department 2019).

It is essential to enforce supervisory directions effectively. The supervisory enforcement function is vital to ensure that banks are complying with the regulatory requirements and their own internal policies and procedures (Bank Supervision Department 2019). Falling under the Bank Supervision Department, the Enforcement Unit is responsible for the proper enforcement of such supervisory directions (Bank Supervision Department 2018, 2019). It has been found, however, that supervisory instructions are not enforced effectively (Bank Supervision Department 2018, 2019). For instance, on completion of their onsite inspections, the Bank Supervision Department prepares reports and provides directions to the individual banks to make corrections on the issues identified (Bank Supervision Department 2018, 2019).

However, banks habitually find excuses and do not take corrective measures on time (Bank Supervision Department 2018, 2019). Banks also commit to making rectifications at some later date (Bank Supervision Department 2018, 2019). Due to the limited supervisory resources, however, follow-up on all the commitments made by the banks has been a challenge for the department (Bank Supervision Department 2018, 2019). Ensuring appropriate corrections measures are made on time has also become a challenge for the Enforcement Unit due to constraints on supervisory resources (Bank Supervision Department 2018, 2019).

The prudential policies adopted, such as onsite inspections and offsite surveillance, are supervisory practices based on the best international norms (Bank Supervision Department 2019). It has been found, however, that there is inadequate integration between the Onsite and Offsite units (Bank Supervision Department 2018, 2019). The reports that the Offsite Unit receives from the banks is an important source of input for onsite inspection (Bank Supervision Department 2018). Still, the Offsite Unit's inputs are not considered when developing the bank's risk profile (Bank Supervision Department 2018, 2019). Likewise, the onsite inspections also do not adequately scrutinise the data integrity of the regulatory reports that are sent to the Offsite Unit (Bank Supervision Department 2018, 2019). The inadequate integration between the Onsite and Offsite units also illustrates that the Nepal Rastra Bank does not have an effective supervisory process in place. Similarly, offsite analysts and onsite inspectors may perform the same analysis (Bank Supervision Department 2018, 2019). These practices show that there are redundancies in the supervisory functions of the Rastra Bank (Bank Supervision Department 2018, 2019). These weaknesses in supervisory functions show that the Rastra Bank is facing challenges to integrate their Onsite and Offsite units fully, which are hindering their supervisory directions and, ultimately, effective enforcement actions (Bank Supervision Department 2018, 2019).

4.5.2 A Dearth of Human Resources Expertise

Human resources competencies have remained a challenge for the Nepalese banking industry. The quality of human resources in the banking industry, and the capacity of banking supervisors, have remained as challenges in the Nepalese banking industry. With the development of new products and services, and adoption of advanced ICT, the Nepalese banking industry is continuously evolving and becoming more complicated (Bank Supervision Department 2019; Nepal Rastra Bank 2013, 2015a). The adaptation of international best practices and national prudential regulatory standards, such as the Basel Norms, in risk

management and corporate governance are placing demands for a more competent skillset and stricter compliance in the banking industry (Bank Supervision Department 2015, 2016, 2017, 2018, 2019). However, in almost every onsite inspection and supervision, a dearth of skilled and competent human resources was found in the banking industry (Bank Supervision Department 2015, 2016, 2017, 2018, 2019). The recent mergers in the banking industry are likely to slash down skilled and competent human resources, mainly from senior management level (Banking Khabar 2019). With more mergers likely to happen in the future, retaining competent human resources in Nepal's banking sector will be more challenging.

Banks operate both nationally and internationally. Therefore, there is a need for understanding rapidly changing financial markets. After the GFC of 2008, especially, supervisors worldwide agreed that there is a need for understanding these rapidly evolving financial markets (Bank Supervision Department 2014). Supervisors also need to understand the risks that new products and services bring with them (Bank Supervision Department 2014). Accordingly, the Nepal Rastra Bank and Bank Supervision Department have made many efforts and channelled resources to enhance the capacity of supervisors and to bring shared understanding on financial issues (Bank Supervision Department 2014). The Rastra Bank and Bank Supervision Department have continuously pursued various trainings, seminars, knowledge sharing and interaction programs (Bank Supervision Department 2014). These programs, conducted both domestically and abroad, have helped NRB Supervisors to bring a common understanding of the changing business environment, as well as to equip them with the necessary resources for effective regulation and supervision (Bank Supervision Department 2014). The effective supervision has, however, become one the major challenge for the Rastra Bank (Risal and Panta 2019) with the NRB's limited supervisory resources and capacity, and the increasing number of BFIs (Bank Supervision Department 2019).

The skills development and resources needed for adapting their supervisory approaches to these continuous changes have also been a constant challenge to the NRB (Bank Supervision Department 2019). For instance, although the Rastra Bank had implemented risk-based supervision (RBS) as the parallel run in FY 2013/2014 (Bank Supervision Department 2016, 2017; Nepal Rastra Bank 2015a), since FY 2014/2015, the Rastra Bank has changed their onsite inspection model from compliance-based to RBS (Bank Supervision Department 2016; Nepal Rastra Bank 2015a). Under the RBS approach, the supervisors should not only identify but also appropriately assess the quantity of risk and quality of risk management for all major risks that banks face (Bank Supervision Department 2018, 2019). There is a challenge for

supervisors; however, to assess those levels based on the issues identified (Bank Supervision Department 2018, 2019). The Bank Supervision Department (2018) further claims that not all supervisors have adequate knowledge and skills to perform their job effectively. NRB supervisors are not adequately experienced to apply the RBS approach effectively (Bank Supervision Department 2018, 2019). The findings from this project are consistent with the claim that the supervisory capacity has not increased in proportion to the complexity of the new banking regulations (Anginer et al. 2019). Thus, skills and capacity development, in term of human resources for both the banking industry and NRB supervisors, can become a challenge for implementing international best practices better.

4.6 Conclusion

This chapter has presented the findings and a discussion of the Nepalese commercial banks' risk governance practices. Notably, by applying *public interest theory* and *agency theory*, the Nepal Rastra Bank was found to be committed to implementing the Basel Norms in commercial banks for the best interests of broader stakeholders even though none of the Nepalese banks meets the requirements for being systemically important global bank (Nepal Rastra Bank 2013). The various risk governance mechanisms that the NRB had adapted from the Basel Accords for the Nepalese banking sector have attempted to make the banks' senior management and boards accountable for their banks' risk management. These therories were useful, therefore, to understand that the risk governance mechanism implemented in the Nepalese banking system, ultimately, would enable the interests of the broader stakeholders to be protected. This chapter also provided evidence that all the sample banks have audit and risk management committees at their board level. The following chapter presents the conclusion of this thesis project.

CHAPTER 5 CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This research project's objective was to describe and explain the risk governance practices of the Nepalese commercial banks, relating to the adoption of Basel's corporate governance principles. This final chapter aims to present the conclusions of the project and provide recommendations. It summarises this project's key findings and discusses their implications. This chapter also explains the project's limitations and areas for future research. Section 5.2 presents a summary of this research project's key findings. Section 5.3 elaborates with the implications of the project's findings. Similarly, the contribution of this project to the body of research, in terms of the risk governance practices of Nepalese commercial banks, is discussed in Section 5.4. The limitations of this project is explained in Section 5.5. Section 5.6 concludes this chapter by presenting recommendations for future research on risk governance.

5.2 Key Findings of the Project

The primary objective of this project was to gain an in-depth understanding of risk governance practices of the commercial banks of Nepal. Research questions were formulated in Chapter 1 and data were analysed in Chapter 4 to achieve this objective. From this project, it can be concluded that Nepal and the NRB are introducing and amending the Acts, legislations and regulations as discussed in Section 4.2, to embrace the international best practices. For instance, the NRB's regulatory mandates in Section 4.2.3, illustrate that the NRB is creating the responsibilities and accountabilities for a risk oversight function to improve the risk governance practices in the banking sector. From these Nepal Rastra Bank's initiatives, it can be concluded that the NRB has undoubtedly made progress in improving the resilience in the banking sector of Nepal. The project's findings are consistent with the earlier studies that have found that the new regulatory frameworks and amendments in the existing legislation have helped in bringing the improvements in risk governance to some extent in the banking industry of Nepal (Luintel, Selim & Bajracharya 2014; Ozaki 2014; Shrestha 2004). These findings can also be related to the claim that the NRB is promoting corporate governance; accountability of

management and board of directors; and risk management (Bank Supervision Department 2018).

The findings also indicate that on the one hand, while some of the sample banks are complying to the NRB's risk governance mechanisms. On the other hand, some sample banks have not sufficiently disclosed the risk governance information to conclude their compliance or non-compliance to the NRB's mandates. Similarly, the Rastra Bank has also not disclosed the information on the non-compliance and the enforcement action related to the risk governance mechanism. In this context, there is no sufficient evidence to conclude their compliance or non-compliance to the NRB's mandates. Thus, this evidence indicates that both the NRB and the bank doe not provide a clear and real picture of the actual risk governance mechanism. These findings are relatable to the findings of Buckby, Gallery and Ma (2015) that pointed out that disclosures about the risk governance, particularly about the risk management activities are either inaccurate or inadequate. However, this research finding indicates that the Nepalese banks are in the process of developing their risk management practices and risk management information disclosures. For instance, during the study period FY2015/2016, not all sample banks have disclosed all the risk governance mandates in their annual reports. However, in FY2017/2018, all of the sample banks have disclosed at least most of their risk governance mechanisms.

In conclusion, there is evidence to support that much work has been done in improving the risk governance practices of the Nepalese banking sector. However, it is also important to note that building an effective risk governance mechanism is endless. Both the NRB and the commercial banks have still a lot more to do to build an effective risk governance mechanism.

5.3 Implications of the Project's Findings

As noted earlier, the NRB and the banks have much work to be done in building robust risk governance mechanisms. The project has found that there is a lack of sufficient risk management disclosures from both the NRB and commercial banks to confirm compliance with the regulatory requirements. This limited information implies that the Rastra Bank and banks should also make their risk management information more accurate, consistent, transparent, meaningful and useful. The Rastra Bank should immediately start to strengthen its supervisory function to both monitor and adjust the appropriate disclosure mechanism (Nepal Rastra Bank 2013). In this context, the Rastra Bank should seek to understand if banks need

any support in the form of technical, educational or other assistance to disclose the risk governance compliance to the regulatory mandates. For instance, the Rastra Banks needs to understand and decide whether there is a need for more clarity in regulation for the disclosure requirements for risk management information. Whether or not the Rastra Bank has to be more prescriptive in the risk information disclosure requirements of the banks. Likewise, it is also essential for the Rastra Bank to identify if there should be any preferred regulatory disclosure method to implement in the Nepalese banking industry. This understanding and decision are necessary, as communication about how risk management is practised and disclosed to the stakeholders by an organisation is one of the essential components in corporate governance (Buckby, Gallery & Ma 2015). These risk information are also increasingly sought by the stakeholders such as investors and regulators (Buckby, Gallery & Ma 2015). Thus, the Rastra Bank should immediately start to find the appropriate disclosure mechanism to ensure the enhanced corporate governance are practised, which is essential for financial safety and soundness.

5.4 Contributions of the Project

Upon its completion, this project has filled the research gap identified in Chapter 1. By filling this research gap, this research project has contributed to two areas. First, this project has made a contribution to the existing literature in the field of risk governance. More specifically, this contribution to the field has been made through two aspects. As discussed in Chapter 1, by investigating the risk governance mechanisms within a different context, which is the Nepalese context in this project has contributed to the field of risk governance. This project has filled the gap identified by McNulty, Zattoni and Douglas (2013); Yusof (2016); and Zattoni, Douglas and Judge (2013). The project has also made a methodological contribution to the risk governance field by using the qualitative research approach. As stated in Chapter 1, there is need for qualitative research studies in the corporate governance field (McNulty, Zattoni & Douglas 2013; Yasin, Muhamad & Sulaiman 2014; Zattoni, Douglas & Judge 2013). These arguments demonstrate that, by using a qualitative research approach, this project has helped to bridge the research gap in understanding concepts of corporate governance and risk management, principles and frameworks, and their application status in the Nepalese banking industry. This research project has thus contributed to the existing literature on risk management and corporate governance through its context and methodological approach.

The second area of contribution is to policy debates. The findings from this project have revealed that both the NRB and the banks do not provide a clear and real picture of the actual risk governance mechanism. Thus, stakeholders such as individual banks, banking associations, regulators, investors and policymakers should challenge accuracies, meaningfulness and usefulness of the current risk information disclosures mechanism of the banks and the NRB. Similarly, as noted earlier, with the consolidation process adopted by the NRB through the merger and acquisition policy, and the increase in paid-up capital requirements, should bring structural changes to the banking system. The gradual entrance of foreign banks into the Nepalese financial system would expand and diversify the country's banking structure. With the Rastra Bank's provisioning to expand BFIs' scope of operations by mandatory issuance of debentures and permission to accept deposits and borrowing from foreign currency sources expose BFIs to face more risks. In such a context, stakeholders should challenge the existing risk governance framework. These stakeholders should also question whether or not the existing regulatory risk management mechanisms are flexible and sufficient for adjusting to future banking challenges.

5.5 Limitations of the Project

There are several limitations to this project. One of the major limitations is that the findings on the risk governance mechanism practices observed in the sample banks may not be replicable in other commercial banks of Nepal. Because this project applied the convenience sampling method to collect the data on risk governance mechanism, the findings do not necessarily apply to all classes of commercial banks in Nepal. In addition, because this project is exploratory research, which sampled only four banks, caution should be applied when generalising the findings from this project.

The second limitation is the project's application of a limited theoretical lens. As observed in Chapter 2, numerous theoretical frameworks can be applied to understand risk governance issues. This project, however, applied just two theories. Because the use of agency theory has been criticised for being overly narrow (Ahrens, Filatotchev & Thomsen 2011), this project findings could be criticised for not using contemporary theories of corporate governance. Thus, the inadequate application of appropriate theories could be another limitation of this project.

As discussed earlier, risk management is multi-dimensional. Some of the crucial facets identified with risk management are the bank's risk culture, risk appetite, risk profile, risk

strategy, management information system (MIS) and risk governance (Bank Supervision Department 2018; Sheedy & Griffin 2018); the CRO's remuneration; and qualifications and experience of the Audit and Risk Management committees (Sheedy & Griffin 2018). Integrating all these dimensions can help to gain a holistic and in-depth knowledge of the risk governance system. This project, however, has focused only on the existence of an active board, board sub-committee and senior management oversight in the organisational structure. Therefore, the use of this single dimension – risk governance – could be another limitation of this project. Given the resource's availability, such as the research study period and word limitations, using risk governance from the Basel Principles and the NRB mandates should suffice to achieve the research project's aim.

5.6 Recommendations for Future Research

This project has identified three broad areas for future research. First is to consider and apply other theoretical lenses for gaining profound knowledge on risk governance practices. Tricker (2019) views that there are numerous theoretical perspectives on corporate governance. In recent times, alternative theories on corporate governance, such as stewardship, resource dependency and stakeholder theory, have started becoming more prominent (Yusoff & Alhaji 2012). In such a context, using contemporary theories will allow governance scholars to produce new and innovative interpretations of corporate governance phenomena (Zattoni & Van Ees 2012). Furthermore, scholars are encouraged to combine existing corporate governance theories (Borlea & Achim 2013; McNulty, Zattoni & Douglas 2013; Yusoff & Alhaji 2012) to interpret governance phenomena (McNulty, Zattoni & Douglas 2013). From these arguments, it follows that using various theoretical frameworks would help governance scholars to explore governance phenomena from different perspectives.

Second, qualitative risk governance scholars can embrace other rigorous research methods to collect and analyse data. McNulty, Zattoni and Douglas (2013) argue that using rigorous qualitative methods to explore governance phenomena can help governance scholars to consider a country's specific legal and cultural foundations, which affect the governance issues of that particular nation. Thus, using rigorous qualitative methods helps in the exploration of a particular country's governance phenomena. Within this context, qualitative scholars can employ research methods such as a focused group interview, either in isolation or in conjunction with other methods to collect data from broader ranges. For instance, the panel in a focused group could include experienced senior officials of the Rastra Bank and commercial

banks, as well as banking experts and policymakers. Conducting a focused group interview with these participants would allow an exploration of how the Basel's Principles for the risk governance mechanism is helping the Nepalese banking industry to build a robust risk governance system. The focused group interview can also assist in gaining in-depth knowledge of how these officials interpret the Basel Principles to fit into in the Nepalese context.

Third, future qualitative risk governance scholars could include other variables such as a bank's risk culture, appetite, profile and strategy; MIS; remuneration of the CRO; and qualifications and experience of the audit and risk management committees to gain an in-depth knowledge of the risk governance system. Sheedy and Griffin (2018) argue that, in banks and financial institutions, risk culture and remuneration structures are crucial components that support risk management. Including these variables in future research might be deemed necessary because risk governance is just one dimension in risk management. Thus, in the above-discussed areas on risk governance, there is scope for future researchers who have an interest in undertaking a research project in Nepalese commercial banks. Incorporating these components in future governance research, therefore, will assist in a profound understanding of effective risk governance.

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Appendixes

Appendix 1-1: Number of BFIs and Other Institutions as of Mid-July 2018

Number of BFIs and Other Institutions as of Mid-July 2018	
Banks and Financial Institutions	**Number**
Commercial Banks (CBs)	28
Development Banks (DBs)	33
Finance Companies (FCs)	25
Microfinance Financial Institutions (MFFIs)	65
Sub-total	**151**
NRB Licensed Cooperatives (Co-ops)	14
NRB Licensed FINGOs (with limited banking activities)	24
Insurance Companies (ICs)	38
Reinsurance Company (RIC)	1
Sub-total	**77**
Securities Market Institutions	
Stock Exchange	1
Central Depositary Company	1
Stockbrokers	50
Merchant Bankers	25
Mutual Funds (MFs)	9
Credit rating Agencies	2
Depositary Participants*	70
ASBA BFIs*	65
Sub-total	**88**
Employees Provident Fund (EPF)	1
Citizen Investment Trust (CIT)	1
Postal Saving Bank	1
Deposit and Credit Guarantee Fund	1
Credit Information Center Limited (CICL)	1
Total	**321**

** BFIs repeated as ASBA BFIs and Depository Participants not included in Total.*

Source: Nepal Rastra Bank (2018, p. 15)

Appendix 1-2: Minimum Regulatory Paid-Up Capital of BFIs as of 2018

Minimum Regulatory Paid-Up Capital of BFIs as of 2018 (in NPR)				
BFIs Types	**National Level**	**Regional Level (within development region)**	**4–10 Districts**	**1–3 Districts**
Commercial Bank	8.00 billion			
Development Bank	2.5 billion		1.2 billion	0.50 billion
Finance Company	800 million		800 million	400 million
Microfinance Institution	100 million	60 million	20 million	10 million

Source: Bank Supervision Department (2018)

Appendix 1-3: List of Commercial Banks in Nepal as on mid-July 2018

No.	Bank's Name	Date of Operation
1	Nepal Bank Limited	1937/11/15
2	Rastriya Banijya Bank Limited	1966/01/23
3	Agricultural Development Bank Limited **	1968/01/21
4	Nabil Bank Limited	1984/07/12
5	Nepal Investment Bank Limited	1986/03/09
6	Standard Chartered Bank Nepal Limited	1987/02/28
7	Himalayan Bank Limited	1993/01/18
8	Nepal SBI Bank Limited	1993/07/07
9	Nepal Bangladesh Bank Limited	1994/06/06
10	Everest Bank Limited	1994/10/18
11	Kumari Bank Limited	2001/04/03
12	Laxmi Bank Limited	2002/04/03
13	Citizens Bank International Limited	2007/04/20
14	Prime Commercial Bank Limited	2007/09/24
15	Sunrise Bank Limited	2007/10/12
16	Mega Bank Nepal Limited	2010/07/23
17	Century Commercial Bank Limited	2011/03/10
18	Sanima Bank Limited	2012/02/15
19	Machhapuchhre Bank Limited	2012/07/09*
20	NIC Asia Bank Limited	2013/06/30*
21	Global IME Bank Limited	2014/04/09*
22	NMB Bank Limited	2015/10/18*
23	Prabhu Bank Limited	2016/02/12*
24	Siddhartha Bank Limited	2016/07/21*
25	Bank of Kathmandu Lumbini Limited	2016/07/14*
26	Civil Bank Limited	2016/10/17*
27	Nepal Credit and Commerce Bank Limited	2017/01/01*
28	Janata Bank Nepal Limited	2017/04/07*
* Joint operation date after merger and/or acquisition.		

** Started to operate as ‘A’ class Bank (from 2006/03) under BAFIA, 2006

Source: Bank Supervision Department (2019, p. 3)

Appendix 2-1: Distinctive Differences between the Roles of an RMC and the Audit Committee

Audit Committee	RMC
Focus	
Historical performance Effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations	Future performance Broader risks of strategic, managerial and operational levels Risks with financial and non-financial consequences
Terms of Reference	
Audit Ensure that the company's external and internal audits are sufficient to address business risks	**Risk Assessment** Ensure that the company's management regularly assess its risks and updates its risk register Ensure that risk assessment is part of the decision-making process, and that risks taken are within the risk appetite level set by the board
Internal control Ensure that management has put in place appropriate internal controls to address business risks Ensure effective functioning of such controls	**Risk Management** Ensure that management has put in place a risk management system to assess, control and monitor all risks Ensure the effective functioning and currency of such a system

Financial Reporting	**Risk Reporting**
Review the company's financial reports, in particular, ensuring that the duties of the directors on disclosure and representation of the company's financial affairs are fully discharged	Review information and reports to the board on the company's major risks and exposures, and their management
Committee Members' Core Attributes	
Analytical Quantitative Financial expertise	Analytical and creative Qualitative Broader experience

Source: Choi (2013, p. 9)

Appendix 3-1: List of Risk Governance Variables to Investigate as per Basel Recommendations and Rastra Bank Requirements

List of Risk Governance Variables to Investigate as per the Basel Recommendations and the Rastra Bank Requirements				
No.	**List of Items to Investigate**	**As Per the Basel Accords**	**As Per the NRB Act**	**As Per the BAFIA**
1	**Risk Governance at Board Level**			
1.1	**Audit Committee**			
	Is the establishment of the Audit Committee mandated in for banks?	Principle 3	Section 60	
	What Are the Audit Committee's Mandates?	Principle 3	Section 61	
1.2	**RMC**			
	Is the establishment of the RMC mandated for banks?	Principle 3		ToR in Unified Directives 2075
	What are the Risk Management Committee's Mandates?	Principle 3		ToR in Unified Directives 2075
2	**Risk Governance at Senior Management Level**			

	Is there an existence of separate risk management function mandated in banks?	Principle 6		ToR in Unified Directives 2075
	Is the appointment of the CRO compulsory in banks?	Principle 6		ToR in Unified Directives 2075
	Can the CRO have 'dual hatting'?	Principle 6		ToR in Unified Directives 2075
	If the dual hatting of the CRO dual is legitimate, what are their functional titles?			ToR in Unified Directives 2075
	What is the reporting line of the CRO, i.e., CEO or Board or Risk Committee?	Principle 6		ToR in Unified Directives 2075
	What is the reporting line of the CRO?	Principle 6		ToR in Unified Directives 2075
	What are the functions, duties and power of the CRO?	Principle 6		ToR in Unified Directives 2075

Appendix 3-2: List of Risk Governance Variables to Investigate in the Sample Banks

List of Risk Governance Variables to Investigate in the Sample Banks			
No.	**List of Items to Investigate**	**As Per the NRB Act**	**As Per the BAFIA**
1	**Risk Governance at Board Level**		
1.1	**Audit Committee**		
	Is there the existence of an Audit Committee in all sample banks?	Section 60	
	What is the composition of the Audit Committee's Mandates in the sample banks?	Section 61	
	Does the CEO or Chairperson of another board sub-committee head the Audit Committee in the sample banks?	Section 61	
	What is the reporting line of the Audit Committee?	Section 61	
	How many times has the Audit Committee's meeting been conducted?	Section 61	
	Have all sample banks disclosed the duration of each audit committee's meeting?	Section 61	

	Have all sample banks fulfilled the mandate given to the committee?		
	What are the functions, duties and powers of the Audit Committee/Purpose of Audit Committee?	Section 61	
	How similarly or differently does the bank's audit committee function against the NRB requirements?		
1.2	**Risk Management Committee**		
	Is there the existence of a Risk Management Committee in all sample banks?		ToR in Unified Directives 2075
	What is the composition of the RMC in the sample banks?		ToR in Unified Directives 2075
	What is the reporting line of the RMC?		ToR in Unified Directives 2075
	How many times has the RMC meeting been conducted?		ToR in Unified Directives 2075
	Have all sample banks disclosed the duration of each risk committee's meeting?		ToR in Unified Directives 2075
	Have all sample banks fulfilled the mandate given to the committee?		
	What are the functions, duties and powers of the RMC?		ToR in Unified Directives 2075

2	**Risk Governance at Senior Management Level**		
	Is there the existence of a separate risk management function in all the sample banks?		ToR in Unified Directives 2075
	Is the CRO appointed in every sample bank?		ToR in Unified Directives 2075
	Does the CRO have 'dual hatting' in the sample banks?		ToR in Unified Directives 2075
	If the CRO has dual hatting, what are their functional titles?		ToR in Unified Directives 2075
	What is the reporting line of the CRO, i.e., CEO or Board or Risk Committee?		ToR in Unified Directives 2075
	Do all sample banks have the same reporting line?		
	What are the functions, duties and power of the CRO?		ToR in Unified Directives 2075

Appendix 4-1: Mandates of the Audit Committee as per the Basel and NRB

As Per Principle 3 (Bank for International Settlements 2015) **On Page 16**	**As Per Section 60 under Bank and Financial Institutions Act 2073 (2017)** **On Pages 62, 63**
Systemically important banks are strongly recommended for other banks based on an organisation's size, risk profile or complexity to establish an Audit Committee;	The Board of Directors of a bank or financial institution shall have to form an Audit Committee.
Audit Committee is made up entirely of independent or non-executive board members.	Audit Committee should comprise of three members under the headship of one non-executive Director.
Audit Committee has a chair who is independent and is not the chair of the board or any other committee;	The Chairperson of the bank or financial institution, convener of the sub-committees and the Chief Executive, shall not be allowed to act in the audit committee referred to in Sub-Section (1).
	Members of the committee referred to in Sub-Section (1) shall not be entitled to be engaged in collecting deposits, disbursing credits, investing in securities, and making decisions in any daily transaction that requires for making expenses out of the approved budget.

	Except in cases of the meeting called by the Board of Directors, meeting of the Audit Committee generally shall be held once every three months.
	Procedures of the meeting of the Audit Committee shall be as prescribed the committee itself.
Audit Committee should include members who have experience in audit practices, financial reporting, and accounting.	
Audit Committee should be distinct from other committees.	

Appendix 4-2: Major Responsibilities and Function of the Audit Committee as per the Basel and NRB

As per Principle 3 (Bank for International Settlements 2015) **On Pages 16, 17**	**As Per Section 61 of BAFIA 2073 (2017)** **On Page 63**
Framing policy on internal audit and financial reporting, among other things;	
Overseeing the financial reporting process;	To ascertain whether or not the accounts, budget and internal auditing procedures, the internal control mechanism of bank and financial institution are appropriate and if they are appropriate, to carry out monitoring and supervision, whether or not they are complied with,
Providing oversight of and interacting with the bank's internal and external auditors;	
	To cause to carry out internal auditing of the accounts and books of records of the bank or financial institution and to ascertain that whether or not such documents are prepared according to the prevailing law, regulation, and directives of the Rastra Bank,

	To conduct or to cause to conduct auditing of management and operation, managerial and work performance of the bank or financial institution to be assured that the laws in force in the bank or financial institution are fully complied with.
Receiving key audit reports and ensuring that senior management is taking necessary corrective actions promptly to address control weaknesses, non-compliance with policies, laws, and regulations, and other problems identified by auditors and other control functions	To carry out monitoring whether or not actions are being taken according to the Act or Rules enacted under the Act, Bylaws, policies or given directives in the bank or financial institution and to submit a report thereof to the Board of Directors,
Approving, or recommending to the board or shareholders for their approval, the appointment, remuneration, and dismissal of external auditors	To recommend names of three auditors for the appointment of the external auditor,
	To furnish opinion on the subjects as required by the Board of Directors.
Reviewing and approving the audit scope and frequency	
Overseeing the establishment of accounting policies and practices by the bank	

Reviewing the third-party opinions on the design and effectiveness of the overall risk governance framework and internal control system	

Appendix 4-3: Mandates of the Risk Management Committee as per the Basel and the NRB

As per Principle 3 (Bank for International Settlements 2015) **On Page 16**	**As Per ToR in Unified Directives 2075 under Nepal Rastra Bank Act, 2002**
The risk management committee is required for systemically important banks and is strongly recommended for other banks based on a bank's size, risk profile or complexity;	The Board of Directors shall have to form a Risk Management Committee.
Risk management committee should be distinct from the audit committee, but may have other related tasks, such as finance;	
Risk management committee should have a chair who is an independent director and not the chair of the board or any other committee;	The Board of Directors shall have to form a Risk Management Committee led by a non-executive director.
Risk management committee should include a majority of independent members;	
Risk management committee should include members who have experience in risk management issues and practices;	

The risk management committee is required to review the bank's risk policies at least annually;	
Risk management committee should be effective communication and coordination between the audit committee and the risk committee to facilitate the exchange of information and effective coverage of all risks, including emerging risks, and any needed adjustments to the risk governance framework of the bank;	
Risk management committee should receive regular reporting and communication from the CRO and other relevant functions about the bank's current risk profile, the current state of the risk culture, utilisation against the established risk appetite, and limits, limit breaches, and mitigation plans.	To regularly receive risk reports from the management, to discuss on how the risks are being estimated, evaluated, controlled and monitored; and to impart needful suggestions to the Board of Directors in this connection.
	The Head of Operations Department shall be its member whereas the Head of Credit Department or a Head of a separate unit looking after risk management, if any, shall be its member secretary.
	The meeting of Committee shall seat at least once in every 3 months.

Appendix 4-4: Major Responsibilities and Major Decisions to be Undertaken by the Risk Management Committee as per the Basel and NRB

As Per Principle 3 (Bank for International Settlements 2015) **On Page 17**	**As Per ToR in Unified Directives 2075 under Nepal Rastra Bank Act, 2002**
Risk management committee should discuss all risk strategies on both an aggregated basis and by type of risk and make recommendations to the board thereon, and on the risk appetite.	
Risk management committee should oversee that management has in place processes to promote the bank's adherence to the approved risk policies.	
Risk management committee's work includes oversight of the strategies for capital and liquidity management as well as for all relevant risks of the bank, such as credit, market, operational and reputational risks, to ensure they are consistent with the stated risk appetite.	

The risk management committee of the board is responsible for advising the board on the bank's overall current and future risk appetite, overseeing senior management's implementation of the RAS, reporting on the state of risk culture in the bank, and interacting with and overseeing the CRO.	To regularly review the level of risks inherent in business activities, risk tolerance capacity, strategies developed for risk management, policy provisions, and guidelines; and to suggest the Board of Directors on their sufficiency.
	To impart suggestions to the Board of Directors as regards developing needful policies and framework as per the directives/guidelines issued by the Nepal Rastra Bank, the internal limits fixed by the institution and suitable practices for risk management.
	To conduct stress testing regularly in the 'A' level commercial banks, to discuss their outcomes, and to impart suggestions to the Board of Directors on the needful policy framing or decision-making for the future, on these bases.
	To review the rationale and limits of power delegation made by the Board of Directors, and to submit a report inclusive of the needful suggestions.

	To conduct a review, every 3 months, on the assets structure of institution, mobilisation status of those assets, income that may be derived from those assets, increase or depreciation of quality of assets, and the functions of Assets and Liability Committee, and to submit a report to the Board of Directors, in this regard.
	To commission a study on the impact that may befall on the financial status of the institution due problems or changes that may pop up in a sector of the economy, and submit a report at the Board of Directors inclusive of the needful suggestions on what policies should be adopted as the remedy.

Appendix 4-5: Mandates of the Risk Management Function and the CRO as per the Basel and the NRB

As Per Principle 6 (Bank for International Settlements 2015) **On Pages 25, 26**	**As Per ToR in Unified Directives 2075 under Nepal Rastra Bank Act, 2002.**
Banks should have an effective independent risk management function, under the direction of a CRO.	Independent risk management function should be headed under a CRO of the institution or an official of similar designation.
Have sufficient stature, independence, resources, and access to the board.	The CRO is required to directly report before the Risk Management Committee on par with Board of Directors in a periodic manner.
The board or its risk committee should approve appointment, dismissal and other changes to the CRO position.	
If the CRO is removed from his or her position, this should be disclosed publicly.	
The bank should also discuss the reasons for such removal with its supervisor.	
The CRO's performance, compensation, and budget should be reviewed and approved by the risk committee or the board.	

The CRO should be independent and have duties distinct from other executive functions.	
The CRO should not be involved in revenue generation, held line responsibility or participated in business decision-making or the approval process.	
There should be no ‘dual hatting’; however, if ‘dual hatting’ is inevitable, these roles should be compatible	The business functions and risk management functions should be so demarcated that there exists no conflict of interest between the two.

Appendix 4-6: The NRB's Mandates for Audit Committee Observed in the Sample Banks

Presence of the Audit Committee in the Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	Yes	Yes	Yes	Yes
2016/2017	Yes	Yes	Yes	Yes
2017/2018	Yes	Yes	Yes	Yes
Total number of members, including coordinator of audit committee of sample banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	3	4	5
2016/2017	No information provided	4	4	5
2017/2018	3	3	4	5
Reporting Line and Independence of the Audit Committee in the Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	Board of Directors	Board of Directors	Board of Directors
2016/2017	No information provided	Board of Directors	Board of Directors	Board of Directors
2017/2018	Board of Directors	Board of Directors	Board of Directors	Board of Directors

Number of the Audit Committee Meeting Conducted by Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	5	15/16	5/9/8
2016/2017	No information provided	4	13	Stated meets the regulatory requirements
2017/2018	16	4	11	No information provided

Appendix 4-7: The NRB's Mandates for RMC Observed in the Sample Banks

Presence of Risk Management Committee in the Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	Yes	Yes	Yes	Yes
2016/2017	Yes	Yes	Yes	Yes
2017/2018	Yes	Yes	Yes	Yes
Total Number of Members in Risk Management Committee				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	3	4	6
2016/2017	No information provided	3	4	5
2017/2018	5	3	4	5
Reporting Line of Risk Management Committee in the Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	Board of Directors	Board of Directors	Board of Directors
2016/2017	No information provided	Board of Directors	Board of Directors	Board of Directors
2017/2018	Board of Directors	Board of Directors	Board of Directors	Board of Directors

Number of the RMC Meeting Conducted by the Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	3	5	3
2016/2017	No information provided	4	6	Stated meets the regulatory requirements
2017/2018	7	4	7	6

Appendix 4-8: The NRB's Mandates for Senior Management Observed in the Sample Banks

Existence of Risk Management Function/Department				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	No information provided	Yes	Yes
2016/2017	No information provided	No information provided	Yes	Yes
2017/2018	Yes	No information provided	Yes	Yes
Existence of CRO as Head of Risk Management Unit				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	Yes	Head of Risk Management Department	Officiating Head of Risk Management Department
2016/2017	No information provided	Yes	Chief Risk Management Officer	Yes
2017/2018	Yes	Yes	Chief Risk Management Officer, Chief Risk and	Yes

			Recovery Officer (CRRO)	
Reporting Line of the Chief Risk Officer				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	No information provided	Risk Management Committee	No information provided
2016/2017	No information provided	No information provided	Risk Management Committee	Risk Management Committee
2017/2018	No information provided	No information provided	Risk Management Committee	No information provided
Dual Hatting of the CRO in the Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	Yes	No	No information provided
2016/2017	No information provided	Yes	No	Yes
2017/2018	No	Yes	Yes	Yes
Other Roles of Chief Risk Officer in the Sample Banks				
Year	**EBL**	**SCB**	**CTZN**	**SRBL**
2015/2016	No information provided	CRO & Senior Credit Officer	No	No information provided

2016/2017	No information provided	CRO & Senior Credit Officer	No	Chief Risk Officer & Company Secretary
2017/2018	No	CRO & Senior Credit Officer	Chief Risk and Recovery Officer (CRRO)	CRO & Company Secretary

Appendix 4-9: Methods for Calculating Capital According to Basel II

Method for Calculating Capital According to Basel II			
	Credit Risk	**Market Risk**	**Operational Risk**
Approaches (from least to most sophisticated)	1. Standardised Approach 2. Foundation Internal Ratings-Based (IRB) Approach 3. Advanced IRB Approach	4. Standardised Approach 5. Internal Models Approach	6. Basic Indicator Approach 7. Standardised Approach 8. Advanced Measurement Approach
Result	Risk-weighted asset value for credit risk	Market risk capital charge	Operational risk capital charge

Source: Apostolik and Donohue (2015, p. 248)